**Maintaining School District Fiscal Stability in an Era of Declining Enrollment: Considerations Toward Revising the Current State School Aid Formulas**

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**Introduction**

Leaders of Michigan school districts are currently struggling with two primary concerns; how to improve student achievement, and how to effectively manage the fiscal health of their school district in the face of declining enrollment and the subsequent loss of state school aid. The irony, not surprisingly, is that the two issues are directly related. Although critics of poor student achievement often attempt to make the case that money is not the answer to improving student performance, it’s hard to imagine school districts getting better by losing thousands, and sometimes millions of dollars in revenue annually that have traditionally been used to provide a range of support services and academic programs for student learning. At the close of the 2014 fiscal year, 57 school districts and public school academies ended the year in deficit, or with a projected deficit for the subsequent year. These deficits ranged from slightly more than $5,000 to more than $169 million dollars in the Detroit Public Schools (Michigan Department of Education, 2014). At the close of the 2014-15 school year the DPS deficit has now risen to $216 million dollars. Although more recent data has suggested that the number of districts in this category may have been reduced somewhat (now 41 at the close of the 2015 fiscal year), 13 districts actually saw an increase in their deficits during this period. The reality is that without substantial change in the way in which the Michigan Legislature funds it’s public schools, districts moving forward will no longer be able to cut their way out of deficit and the list of financially distressed districts will continue to grow, ultimately affecting students, their families, and the communities they serve. In yet another barometer of the growing fiscal stress on Michigan school districts, Moody’s Investor Service since 2009 has downgraded the credit rating in 150 of the 206 districts that Moody’s rates making it more costly for those districts to borrow money to meet cash flow requirements until state aid payments begin annually in late October. To address this critical funding issue, this paper draws on data provided by two important documents. The first is Memorandum No. 1131 from the Citizens Research Council of Michigan (CRC) entitled Managing School District Finances in an Era of Declining Enrollment, released in January, 2015. The second is an MSU Extension White paper entitled Knowledgeable Navigation to Avoid the Iceberg: Considerations in Proactively Addressing School District Fiscal Stress in Michigan by White, R., Martin, K., & Bowman, K., released January, 2015.

**The Problem**

Prior to 1994 and the passage of Proposal A by the people of Michigan, school districts were primarily funded by local property tax for school operations. By 1993 a total of 177 Michigan school districts received all of their school operating revenue from local property tax (out of formula districts). The remaining 381 school districts (in formula districts) received the majority of their operating revenue from local property tax supplemented by state aid to reach their foundation allowance. This meant that if a student left a school district for any reason, most of the revenue, and in the case of out of formula districts all of the revenue, remained in the district as locally owned revenue obtained though locally approved property tax and was simply more money available to students who remained in the district.

Proposal A, beginning with the 1994-95 school year fundamentally changed that result in the sense that the primary source of school funding for school operations would come not from local property tax but from the State School Aid Fund (SSAF) in the form of pupil membership aid. Since it was no longer local revenue but now state revenue, the funding was linked directly to the student and would follow the student to their next school, and would also be lost to the district if a student left the state. Proposal A provided Michigan citizens with substantial property tax relief, increased equity between school districts, and improved adequacy for the lowest funded school districts in the state. What it did not do, however, was to provide for financial stability in Michigan school districts. Dramatically reducing local property tax (the most stable form of revenue) and replacing it with an increase in the state sales tax placed the SSAF annual revenue stream subject to sharp down turns in the state economy. This has resulted in uneven and disruptive funding in the state minimum foundation allowance for Michigan school districts. The 2014-2015 minimum per-pupil foundation allowance for schools ($7,251) is $65 per- pupil below the 2010-2011 peak. For schools at the maximum level, it’s $390 below the fiscal year 2010-2011 peak (Michigan House Fiscal Agency, January 2015). A closer examination of the overall funding that has been provided to school districts reveals that a major portion of annual state funding increases has been used to shore up unfunded liabilities in the Michigan Public School Employees Retirement System (MPSERS) to address legacy costs. On average, nearly $1,400 of a district’s per-pupil revenue in 2012 never made it to the student, but instead went directly toward MPSERS payments (CRC, 2013) and that trend has continued throughout the 2014-2015 school year.

The other major cause of financial distress in Michigan school districts is the more serious direct loss of revenue as a result of annual enrollment decline. Since Proposal A now couples state revenue to each student, fewer students means less revenue. As a result of demographic factors in Michigan, e.g., birth rates not at replacement levels and out-migration of Michigan families to other states for employment purposes, Michigan’s student population has declined 11 percent from 2002-2003 to 2013-2014 and that trend continues. Rather than reducing the number of school districts, the number has actually increased from 571 districts in 1994-1995 to 845 districts in 2013-2014 largely driven by the proliferation of charter schools. As the CRC report notes “ Quite simply, the public school enrollment pie is getting smaller, and that shrinking pie is then being sliced into a greater number of pieces. As a result, more districts are losing population. Seventy-one percent of all traditional districts experienced some degree of population loss between fall 2013 and fall 2014 students counts”. (Citizens Research Council, NO.1131, p.2). The CRC report further notes that from 2003 to 2012 enrollment declined in 420 districts and such declines were uneven in their severity. In 95 traditional districts, enrollment losses exceeded 25 percent. Such losses are particularly acute in urban districts where large numbers of charter schools are competing for students. The poster child for the effects of declining enrollment is the Detroit Public Schools (DPS). In the last 10 years, DPS lost more than 100,000 students, now educating approximately 48,000 students representing a market share of 42 percent of the 120,000 students in the city. As a result, the accumulated unrestricted deficit has grown to $169.5 million at the end of fiscal year 2014, an increase from $75.6 million from 2013. The current accumulated deficit is expected to exceed $400 million (Financial and Operating Plan, Detroit Public School District Office of Emergency manager, February 27, 2015). This nexus of severe enrollment decline in a majority of districts through factors largely outside their control, along with an economic climate that sharply limits revenues available for funding public education, has provided the perfect storm that has resulted in a substantial number of school districts and some charter schools to hemorrhage money, resulting in deepening financial distress that allows them few if any options to reverse that course. As lawmakers consider future actions for a new State School Aid Act, strong consideration must be given to alternate models of funding that, at least in the short term, allow school districts to stabilize their financial condition. At present, for many districts the annual financial budget process is akin to “shoveling sand”. As districts deal with a current year budget shortfall, often unknown until final student counts are completed four weeks into the school year, painful cuts are made only to be repeated the next year as enrollment decline continues. Eliminating programs and services, often closing neighborhood schools, only exacerbates the problem causing further enrollment loss in those districts as angry parents seek other options for their child. What seems clear is that the present model for funding schools is no longer rational given that the vast majority of districts are losing students. The current formula will continue to drive many districts into financial insolvency. It is time for the legislature to consider possible remedies if they wish to avoid “bailing out” districts no longer able to erase accumulated debt. As an April 15, 2015 Citizens Research Council report (No. 1135) has noted, “the State of Michigan lacks a clear and consistent statewide policy related to the provision of additional financial resources to financially struggling school districts. Formulating such a policy should be a top priority for state policymakers”. (p.1) What is needed, and needed now, is a kind of medical triage that first “stops the bleeding” and gives districts in financial distress the ability, over time, to right-size their districts, avoiding the immediate loss of large amounts of revenue occurring each school year through enrollment decline that drives many districts into financial insolvency.

Some Possible Solutions

Both the CRC report (No.1131) and the MSU Extension White Paper, noted earlier in this paper, recommend early warning systems for districts experiencing financial distress. If placed in this watch status, direct state technical assistance officials would be required to work with local district staff to identify financial procedures and practices that could be employed to immediately reduce costs throughout the district. This remedy, of course, assumes that the major cause of financial distress in most districts is weak and ineffective fiscal management of district resources and that local school boards are unable or unwilling to make the hard choices necessary such as closing schools, privatization of services, reduction of staff, renegotiating collective bargaining agreements over wages and benefits, and eliminating programs and services for students that are deemed unaffordable. While I do not believe that such fiscal neglect is the case in the majority of districts in financial distress, it does raise a larger philosophical question about education adequacy. This is best illustrated through the now infamous Kalkaska case of two decades ago, where the Kalkaska board of education refused to operate what they viewed as a sham educational program rift of quality educational programs and services for it’s students, and vowed to operate a full educational program until the money ran out at which time the district would be shut down. True to their word the district ended the school year early drawing the wrath of then Governor John Engler who chastised them for not engaging in massive cutting measures that he claimed other districts had done. This action gave impetus for what is now Proposal A that essentially resulted in a state financed school system. Proposal A as we now know, however, did not solve the problem of district financial distress since an unintended consequence of the current funding model is the coupling of funding to student enrollment. While technical assistance may be of some help to a small number of districts where revenue losses are marginal, no amount of technical assistance will solve the larger problem for those districts experiencing heavy annual enrollment losses. Consider that the Detroit Public Schools are now under their fourth state appointed Emergency Financial Manager and during that time the deficit has continued to grow substantially in spite of sustained technical assistance. While technical assistance can be helpful for districts experiencing early and moderate financial indicators of distress, the MSU Extension White Paper wisely notes that “given that districts headed toward or in financial distress are already financially strained, a thoughtful system should not withhold funding from fiscally distressed districts or ask such districts to expend additional resources on data collection and transmission. A significant amount of publically available data exists that, when aggregated and analyzed, can provide state government and districts with great insight into districts financial health”.(p.9)

Other potential remedies are available to the legislature that would more directly address the root cause of financial distress in school districts given the current enrollment decline crisis. The CRC memorandum (No.1131) correctly notes that there is a mismatch between the marginal cost decrease and the marginal revenue decrease that creates inefficiency in the allocation of per-pupil resources. When a student leaves a district not all the costs associated with the student also leave. While a district may be able to reduce some instructional spending as a consequence of educating fewer students, the major costs such as teacher salaries and benefits, do not change unless enrollment change is large enough to allow an entire classroom (e.g.3rd grade) to be eliminated which is usually not the case since enrollment decline is spread across multiple grades, classrooms and buildings making such reductions difficult in the short term. Given this reality, The CRC recommends that policymakers consider modifying the per-pupil foundation grant so that the marginal revenue that a district loses or gains is closer to the actual marginal costs either up or down. This could apply only in the case of enrollment fluctuation districts using a different metric to determine the real costs of financial loss per student and subtracting that from the entire per-pupil foundation amount that would have been lost to the district.

Closely related, and perhaps less complicated, is a return to a blended count formula of the past, also recommended in the CRC Memorandum (No.1131). This concept of counting part of the previous year’s enrollment, blended with the current year’s enrollment, was an attempt by previous legislatures to soften the loss of per-pupil aid for the next year by counting a part of students who are no longer enrolled in the district. The total per-pupil loss would not fully occur until the second year, giving districts more time to respond to necessary cost reductions. In 1998/99 the blended count was 60/40 followed by 75/25 in 2000, 80/20 from 2001-14, 75/25 from 2005-11, and 90/10 beginning in 2012-13 (Michigan House Fiscal Agency). Initially adopted to assist urban districts that were the first to experience enrollment decline, the concept has held less favor with more recent legislatures since a majority of districts are losing enrollment and now represents excess costs by paying for students who are no longer in that school. A return to a substantial blended count formula, blended over two school years or using a three year average, would provide some short term relief for districts losing large numbers of students and give them additional time to adjust costs avoiding draconian cuts in the middle of the school year. (At the time of this writing, the Governor included in the proposed fiscal year 2017 State School Aid Act, a return to a 50/50 blended count over two academic years. While a step in the right direction, the level of relief needed for districts suffering large enrollment loss is only provided temporary relief for one year).

A yet more bold approach to assist districts experiencing severe enrollment decline and subsequent deep financial distress, would be to allow severe enrollment loss districts to keep their current funding, but forfeit any annual increase in the per-pupil foundation grant for existing students. Such transitional aid gives opportunities for districts experiencing large enrollment loss time to adjust for revenue shortfalls. Using as an example, district A with 2,000 students, losing 100 students in the next school year, with a current minimum foundation grant of $7,251 and a projected base increase of $100 per-pupil, the current formula would result in the district losing $735,100 ($7,351 x 100 students) but receiving $190,000 (1,900 students x $100) for a net loss of $545,100 for the new fiscal year. In this example, under a new formula, the district would not lose $735,100 but by forfeiting the annual increase in per-pupil revenue any future inflationary increase in costs would come from savings accrued in the district through educating fewer students. For all districts there would be a “tipping point” where a district might fare better financially by accepting the enrollment loss penalty but taking the per-pupil increase for the remaining students. Using, as an example, district B with 2,000 students and losing ten students in the next year, the anticipated loss would be $73,510 ($7,351 x 10 students) with a projected increase of $199,000 (1,990 x $100) a net gain of $125,490 for the next school year. Under this formula school districts are stabilized financially eliminating any need for state “bail outs” such as that currently being considered for the Detroit Public Schools. It simply makes more sense to financially aid districts at the front end, rather than waiting until districts have amassed huge accumulated deficits while providing reduced educational opportunities for children, and then bailing out districts after the damage is done to the children they serve. Longer term issues that may develop over equity in per-pupil spending if occurring could be handled with equity payments much as the state currently does.

While there are undoubtedly other possible modifications to the current state aid formula, any state funding model should “first do no harm” in the sense that districts should not suffer sanctions and penalties for conditions that are largely created by state educational policies and are beyond the control of local districts to change.

Charter Schools and Choice

In addition to demographic changes resulting in fewer students statewide, the other factor exacerbating enrollment decline in traditional school districts has been the creation and expansion of charter schools as well as transfers through inter-district choice. Charter schools continue to be a contentious issue between those who support choice and a market driven approach to establishing schools, and those who believe that such an approach is tearing at the very fabric of traditional public education and are not the values that protect the common good (Price,W. & Jankens, B., 2015). While it is not the purpose of this paper to debate the merits of charter schools, what is clear and has been noted earlier, is that Michigan simply has too many schools. We are now operating two parallel school systems (and in the case of the Education Achievement Authority three school systems) under different governance models at huge excess costs to the taxpayers of Michigan. Consider, for example, that most traditional school districts now have excess capacity as a result of closing buildings, many of which still carry bonded debt payments. Voters approved $2.1 billion in bonds in 1994 and 2009 to pay for capital improvements on Detroit Public School buildings and still owe $1.5 billion. Today 110 of those buildings are empty or have been torn down but voters will still have to pay for the $106 million that was spent on renovations plus interest on those buildings. Taxpayers will be paying off that tab until 2040 (Detroit Free Press, 2013). Sadly, at the same time charters are establishing schools often in a large assortment of facilities such as closed churches, former YMCA’s, store fronts, or in new schools constructed by for-profit management companies that are leasing them back to their charter schools often at inflated rental charges (Detroit Free Press, 2014). At a minimum the state legislature should address this issue by creating incentives for both traditional districts and charter schools to share facilities by providing additional aid to charter schools that lease space from traditional school districts as is done in other states by creating monetary incentives for both parties to share facilities. Currently, a charter school’s entry into a traditional school district increases the number of school buildings increasing both facility and maintenance costs to taxpayers.

Excess cost is also reflected in the fact that charter schools have no taxing authority and as a result the state must pay the entire minimum foundation grant since there is no portion of that foundation grant paid from non-homestead local property tax. Worse than that, charter schools particularly in urban areas have mixed results in student achievement with most scoring well below state averages in math and reading. For-profit management companies are now reluctant to operate charters as “turn around schools” as they now realize how difficult it is to achieve that task. If charters are not producing exemplary schools there is little justification for having them. The market is badly oversaturated with in-effective schools. There are whole swaths of neighborhoods without a single high-performing traditional or chartered school that children continue to attend because of transportation or information barriers. Now that charters constitute large portions in many cities such as Detroit, they can no longer act as an escape valve from that system. They are the system! Ineffective charter schools simply drain badly needed resources needed from traditional schools and harm students who are left in the traditional schools, often the most difficult to educate.

The state legislature must address the overabundance of charter schools operating at huge excess costs to taxpayers. No additional schools should open until the large number of underperforming schools

are closed and only then opened by operators who have a proven track record of creating successful schools.

A Proposal to Revise Non-Homestead Operating Millage Elections

Although not directly related to the issue of enrollment decline, the Michigan Legislature also needs to address the financial waste associated with elections conducted for the annual school district levy of 18 mills on non-homestead property. As part of replacing some of the school operating millage lost through the 1993 legislative repeal of all school operating millage in Michigan, Proposal A restored six mills on all taxable property as a state education tax and restored, with local voter approval, 18 mills on non-homestead property as a local school district

operating tax. Proposal A established the six mills state education tax as a charter millage, not subject to the Headlee rollback provision. This means that the legislature never has to conduct any renewal vote on the millage and since local districts are legally required to levy the full six mills each year, there is no loss of revenue to the state as a result of the Headlee rollback provision. Local school districts “have the option”, with voter approval, of levying up to 18 mills on non-homestead property as part of their annual school operating revenue for their school district. The reality is that it is not really an option. The amount of money generated by the 18 mills levied on non-homestead property (local operating revenue per-pupil) is subtracted from the district’s foundation grant and the state funds the difference to bring each district to their foundation grant. The state assumes that every district will levy the full 18 mills annually. Under the current requirements, therefore school district millage elections are not really a choice since districts must have revenue from the non-homestead tax to reach their minimum foundation guarantee from the state. If such elections are not successful, the district must continue to hold subsequent elections until the proposal passes and can be legally levied. There are also a substantial number of school districts that levy less than the full 18 mills due to the Headlee rollback requirement and represents money lost to students. Such elections, therefore, are redundant, costly to conduct, and an extra burden on local districts where in reality it is not a choice to voters,

The legislature should revise the state school code to allow any local school district to ask voters to approve the 18 mills as a charter millage, not subject to Headlee, that will eliminate any future need for holding such elections, saving thousands of dollars state-wide that could be better used for instruction. Many districts are already circumventing the effect of Headlee by asking voters to approve “extra” authorized millage to be held in reserve to replace any portion of the 18 mills lost to a rollback, an ethically questionable practice at best. The legislature could and should end useless elections for school districts, saving thousands of dollars and costing the state nothing.

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