CRC MEMORANDUM

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Options to Address School District Accumulated Deficits

A June 2012 CRC report (*State Bailouts to Erase School District Accumulated Deficits*, CRC Memo 1112) highlighted the fact that despite the presence of an emergency manager appointed pursuant to the Local Government and School District Fiscal Accountability Act (Public Act 4 of 2011), resolving the financial crisis in the Muskegon Heights School District is going to require the infusion of additional state funds, in addition to a series of budgeting and management reforms. Public Act 4 does not contemplate the provision of additional funds as a solution, either in whole or in part, to resolve the financial challenges faced by local governments and school districts. Rather the contrary is true. Public Act 4 requires that an emergency manger's financial and operating plan must provide for conducting the operations of the local government or school district "within the resources available" (MCL 141.1518). However, the Muskegon Heights School District emergency manager has indicated an inability to both liquidate the accumulated deficit of the district and provide for the required educational services using only the resources available to him. If the emergency manager is correct in his assessment, a public policy question arises, "What options, short of bankruptcy, are available to fiscally failing school districts to help them simultaneously liquidate their accumulated deficits and ensure that their students receive the educational services and programming they deserve?"

This report addresses this question by highlighting some options for state policymakers. In each case, the suggested solution is limited to school districts under the control of emergency managers and any additional funding, regardless of its source, must be used to address the legacy costs of the district, not for current operational costs. In weighing each option, consideration should be given to when and under what circumstances additional resources should be made available to financially distressed school districts. Specifically, should this be a decision solely made by the emergency manager for the school district working within the constructs of current law? Or, should this be the call of state policymakers? Should the additional funds come from the state or from local sources? What metrics or measures should be used? Should the specific conditions and measures for the provision of additional funding be written into Public Act 4, or another statute? Or, should the decision be made on a case-by-case basis?

Charter Conversion

The current plan of the Muskegon Heights School District emergency manager involves simultaneously converting the entire district to a charter school and redirecting a dedicated local school operating millage to eliminate the outstanding deficit and legacy costs. It is only through the unique interaction of Public Act 4, the charter conversion, and the state's school finance system (specifically the per-pupil foundation grant) that provides the Muskegon Heights School District emergency manager with the ability to maintain school operating funding amounts and, at the same time, erase the accumulated deficit by receiving additional state resources.

Under this plan, the dedicated revenue from the local 18-mill non-homestead tax used to finance the foundation grant would be replaced, nearly dollar-for-dollar, with funds from the School Aid Fund. These local resources would then be used each year to pay down a portion of the district's accumulated deficit, while additional state dollars would be provided to finance the per-pupil grant. In a backdoor way, the additional funds for deficit reduction come from the State of Michigan instead of a local source. And in drawing the additional funds from state resources, fewer funds will be available for all other school districts and students in the state.

According to the emergency manager, the current solution is being offered to stave off bankruptcy and only after other options (e.g., consolidation with another district, annexation, and bankruptcy) were considered and determined not to be viable. In the end, the Michigan legislature will not be involved in the charter conversion decision, the determination of whether addi-

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tional state funds should be provided, or the actual provision of these funds. As the only method currently on the table in Muskegon Heights, is this backdoor approach the model for future cases? Could an elected school board of a traditional public school district facing extreme financial problems, but not under the control of an appointed emergency manager, elect to convert the entire district to a charter in order to use the 18-mill tax as a mechanism to address its fiscal problems in lieu of making the requisite financial decisions?

Direct State Appropriation

Another option would involve a direct state appropriation in the amount of the school district's accumulated deficit. This approach would represent a direct state bailout. This would leave the emergency manager with the responsibility for restructuring district finances and educational services prospectively. As a result, the district would be presented with a "clean slate" in terms of its lingering deficits and allow the emergency manager to avoid the difficult financial decision of whether to allocate scarce resources towards past deficits or spend the money on educational services for current students. This type of state assistance could be provided separate from the educational reforms proposed by the emergency manager. (Under the Muskegon Heights School District plan, the charter conversion is seen as a means to address both the district's financial problems and the educational challenges, simultaneously.)

A major challenge with this approach would be crafting the triggering conditions for the provision of additional state aid. These could be written into Public Act 4 so that only an emergency manager could, based on demonstrated need, request state assistance. The money would be deemed transitional to allow the emergency manager the needed time, and resources, to restructure district finances. Similar to the current solution for Muskegon Heights School District, the costs of liquidating a past deficit would be borne by all Michigan school districts through reduced allocations from the state School Aid Fund. However, a key difference would involve the participation of the Michigan legislature in authorizing a separate appropriation. Most recently, the Michigan legislature appropriated an additional $4 million (up to $4,000 per pupil) to ensure that the students in cash-strapped Highland Park City Schools receive educational services through the end of the 2011-12 school year. These state funds were not designated for past deficit elimination, but they effectively served as a mid-year state operational bailout for the district.

A Local Tax

Prior to the adoption of statewide ballot Proposal A in 1994 and the implementation of the current school finance system, the State of Michigan allowed districts to raise additional local revenues through general obligation borrowing to address an operating or projected operating deficit in excess of $100 per pupil. Unlike the situation today, prior to 1994 school districts had a great deal more control over the amount of locally-raised revenue they had to support operations. Much of this control, including the authority to levy local taxes to address their accumulated deficits, was lost with the shift to state control over the amount of revenue school districts have for operations.

Pre-Proposal A, school districts were required to levy additional taxes to meet the annual principal and interest payments of the bonds or notes issued to liquidate past or projected deficits. Unlike other taxes, the deficit levies did not require a vote of the people.[1] These millages were required in addition to other taxes levied by the district, such as school operating and capital

[1] The authority for school districts to levy these taxes was in place before the 1978 Headlee Amendment to the Michigan Constitution (Article IX, Section 31) that requires local voter approval to levy a new tax (those authorized after 1978) or increase the rate of a new tax.

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construction levies. The Michigan Departments of Treasury and Education had strong oversight roles in these deficit borrowings, including the initial determination of the deficit situation. Seven school districts were levying the millage on January 1, 1994, when the authority to issue deficit bonds or notes was suspended.[2]

Under this state policy, satisfying school district accumulated operating deficits entailed the provision of additional local revenues, but no additional state resources. Borrowing allowed districts to immediately satisfy the deficit, but these borrowings were financed through higher taxes paid by all taxpayers in the local community over a number of years. Voters did not have a choice in authorizing deficit levies, but instead higher taxes were levied without a vote of the people. (One prerequisite to the borrowing and additional taxes was evidence provided to the Department of Treasury that the school district was unable to gain voter approval to increase taxes to address the deficit.)

Amendments to The Revised School Code (Public Act 451 of 1976) could reignite the authorization previously allowed. This could be a power granted only to those districts in receivership under Public Act 4. This power would be in addition to, not in place of, a requirement that an emergency manager makes all budgetary and management reforms necessary to ensure that a school district achieves and maintains a balanced budget prospectively. Also, the authority would be separate from the powers granted to the emergency manager to reform the educational system. The additional local resources would be available one-time only. The taxes necessary to satisfy the annual debt service would be authorized by the emergency manager (on behalf of the school district) and would be paid for by all local taxpayers.

Consolidation with State Assumption of Accumulated Deficit

State policymakers have been pushing for intergovernmental collaboration, service sharing, and consolidation among all types of local governments, school districts included. There is evidence that local governments have engaged in this behavior on their own, as well as in response to encouragement from state government. However, the mammoth deficits of some school districts have deterred consideration of consolidation with nearby districts as a viable option for addressing the financial and educational challenges in the struggling district.

Current statutory provisions contemplate voluntary, not state-mandated, consolidations. However, state policymakers might consider changes in state law to allow for forced mergers for districts in receivership. By providing additional state financial resources to liquidate the past deficits and cover the transitional costs of the newly consolidated district, the state could force fiscally distressed school districts into consolidations. These resources could be provided via a separate appropriation to the school district or through a grant program set up in state law. By paying down the accumulated deficit, a primary obstacle to consolidation is removed.

Choosing an Option

A foundational premise of Public Act 4 and the powers granted to emergency managers under the Act is that local governments and school districts in fiscal distress can, and should, manage within the resources currently available to them. In other words, the cause of their fiscal distress is not a resource problem, but a combination of governance and financial management problems. However, recent actions in the Muskegon Heights School District and Highland Park City Schools suggest differently. In both cases, the emergency managers appointed under Public Act 4 have indicated an inability to both liquidate the accumulated deficit of the school district and provide the required educational services within the resources provided. Instead, a plan has been adopted that effectively provides the Muskegon Heights School District with additional state resources to help it take care of past deficits without reducing the amount of funding available for current operations. However, this is occurring without a clear, consistent, statewide policy.

If Michigan policymakers accept the premise that some financial challenges facing school districts cannot be

[2] Clintondale Community Schools (4.87 mills), Detroit City School District (1.84 mills), Garden City School District (1.9 mills), Highland Park City Schools (5.7 mills), Huron School District (2.23 mills), Madison Heights School District (3.79 mills), and Pontiac City School District (1.8 mills).

solved within existing resources and additional funds are needed specifically to address past deficits, then these funds should have their origins in a state policy as opposed to an ad hoc solution proposed by an emergency manager. Such a policy might provide a single mechanism to supply school districts with additional resources, or it might offer multiple mechanisms contingent on the specifics of each case. The policy, at a minimum, should be transparent, equitable, consistent with other reforms, and transferable.

Because only select school districts will benefit from the provision of additional resources, it is important that the policy is transparent. This includes everything from the identification of eligible districts to the determination of the amount of additional resources. It should be clear to all why the additional resources are needed in the first place and why alternative solutions to the school district's financial problems are not adequate. Ideally, this should be spelled out in state law; either Public Act 4 or another state law.

An equitable policy attempts to assign some responsibility and costs, financial or otherwise, to the school district receiving the additional resources. While a bailout in some form without any "strings" attached might be the preferred solution for a school district, this would not be equitable for all other districts in the state, especially if they are responsible for 100 percent of the costs. Such bailouts can set a bad precedent for dealing with similar future situations. At a minimum, a school district receiving additional funds should be responsible for shouldering some of the burden associated with the resources. This might come in the form of an additional tax and/or restructuring the finances and organization of the school district.

The provision of additional resources would have to accompany both governance and administrative reforms to make sure the school district is financially solvent in the short- and near-terms. At a minimum, balanced budgets should be the norm, sound money management practices should be in place, and employee and other contracts should not be entered into that would lead the district down the same path of deficit spending. Ultimately, state policymakers must take the requisite actions to foster public confidence that districts receiving help to address their accumulated deficits will not be seeking forgiveness again 10 to 15 years down the road. (A number of the school districts that levied deficit millages in 1994 are under the control of emergency managers today and may seek additional financial resources to help address their deficits.)

Finally, the policy should be transferable to all school districts in similar circumstances. The policy should not discriminate based on the geographic location or size of the school district. Consideration should be given to the size of the per-pupil deficit and whether an emergency manager can address the problem within current resources, but less emphasis should be placed on the amount of the total deficit in determining whether additional resources will be made available.