

SCHOOL DISTRICT DISSOLUTIONS:

ANOTHER APPROACH TO ADDRESS LOCAL SCHOOL DISTRICT FISCAL DISTRESS

Every year, a number of Michigan children take advantage of one of the state's educational choice options and move to schools outside of their resident school district. Families availing themselves of these options carefully weigh the educational offerings of their resident district against alternative providers (e.g., other local districts, charter schools, and, more recently, cyber schools) to find the best educational fit for their student. For the 2013-2014 school year, students in two districts did not have the option to attend schools in their resident district because their districts were not deemed "financially viable" by state officials and were dissolved during the summer under a new state law (Public Act 96 of 2013). Instead, the students of these former districts were assigned to schools in neighboring districts by the area intermediate school district.

The dissolution of any unit of local government is a serious matter as it marks the finality of a community institution that many residents deem important and have come to rely on for needed services. This is especially true when the dissolution is involuntary and not the direct result of local decisions by elected officials or by a vote of the people affected. Dissolving a school district is no exception given the emotional and sentimental attachment that many residents have to their neighborhood school and in light of Michigan's strong traditions of local control of public K-12 education.

The state's primary mechanism for dealing with local government fiscal emergencies is Public Act 436 of 2012 (Local Financial Stability and Choice Act).¹ However, instead of invoking Public Act 436 to address the fiscal distress in these two districts, policymakers enacted a new law to allow the state to deal with financially troubled traditional local school districts in a much more expeditious way. Through this mechanism, state officials bypass the deliberative processes outlined in Public Act 436 and,

after determining that a school district is no longer financially viable, close all of the district's schools and assign its students to other districts. This ends the district's role as a K-12 education provider, although the district continues to exist but only to levy previously authorized taxes. Additionally, the new dissolution process allows the state to provide additional state dollars to erase the dissolved district's outstanding debts, something it is unable to do under Public Act 436.

It is unclear if Public Act 96 was intended as a "one off" policy response to deal with the two districts, or if it will become a permanent tool available to state officials to intervene in local school district affairs. However, the adoption and implementation of a new school district dissolution policy signals that state officials are continuing to search for a policy solution to deal with financially failing school districts. Also, this policy highlights the fact that the state does not have a uniform model to use when officials decide that a district is no longer financially sustainable.

Because the new law is written in a way such that it could apply to other school districts dealing with financial challenges, policymakers should consider a number of salient issues before dissolving more districts. The issues and questions surrounding Public Act 96 extend beyond the specific circumstances associated with the two districts recently dissolved, but these situations should motivate a broader examination of school district fiscal distress and the state's response(s). The public policy implications associated with the new law are both broad and narrow in scope. Broad questions deal with the underlying causes of school district fiscal distress and how the structure and functioning of the current school finance system contribute to distress. Questions also arise about the state's departure from prior laws that require local voter approval to alter school district boundaries. The more narrowly focused ques-



tions touch upon implementation issues surrounding the dissolution of school districts and factors that are important to consider, but are not contemplated in the new law.

This memorandum seeks to shed light on the questions and considerations raised by the enactment of Public Act 96 to help guide future state policy responses to school district fiscal distress.

Background: Fiscal Distress and the State's Response

Although not widespread, an increasing number of Michigan school districts are dealing with fiscal distress. The causes of fiscal distress are many, and any number of factors can be at work in a given situation. While each district's situation is unique, some factors, such as declining enrollment, rising retirement costs, and per-pupil funding cuts, can become particularly problematic under the current financing model.² District enrollment losses are attributable to statewide population trends over the recent decade (Michigan was the only state to lose population between 2000 and 2010 and its school-

age population declined by almost 13 percent from 2000 to 2012) as well as policy decisions that have increased competition for students among districts.

Michigan's system for funding school operations ensures that funding follows the student to the district ("district" meaning both traditional public schools and charter schools) of his/her choice. If school choice results in a net reduction in students from a district, the district realizes an overall funding reduction. The finance system is structured such that districts are required to absorb these revenue losses by reducing

Here Today, Gone Tomorrow: What Happened to the Buena Vista and the City of Inkster School Districts?

In July 2013, the state superintendent of public instruction took the unprecedented step of dissolving two local school districts (Buena Vista and the City of Inkster) after the superintendent and the state treasurer determined that both districts met all the conditions of a new state law triggering a dissolution, including being deemed no longer financially viable. Both districts operated full K-12 programs. The financial problems leading to these dissolutions were prompted by consistent declining enrollments, deficit budgets, staff turnover, and fiscal mismanagement. The specific criteria and authority for dissolving local districts is contained in Public Act 96 of 2013, which took effect in July. The dissolutions closed all the schools in these two districts and ended their roles as K-12 education service providers. However, they will continue to exist as separate taxing entities only for the purposes of levying previously authorized taxes. These unique taxing entities will cease to exist when the districts' outstanding debts are retired.

The intermediate school districts (ISD) in which both districts were located effectively divided up the geographic territory of each district and allocated it, along with the students residing in those territories, to surrounding local school districts. The property and student reassignments were effective with the start of the 2013-14 school year. The ISDs also assigned the dissolved districts' records, school buildings and other real property, and funds to the other receiving districts. Officials of the receiving districts (e.g., elected boards and district leadership) determine if, and how, to employ the physical assets of the dissolved districts. All the schools and the related programming of the Buena Vista and Inkster school districts were closed and the former students are being educated in the receiving districts' schools using their programming. Students from the Buena Vista School District were assigned to – the Saginaw City School District, Bridgeport-Spaulling School District, and Frankenmuth School District, while former students of the School District of the City of Inkster were assigned to – the Romulus School District, Taylor School District, Wayne-Westland School District, and Westwood School District.

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expenditures, or by tapping into rainy day reserves, to maintain operating budget balance. School districts have almost no authority to raise additional revenue from local sources under the highly centralized system. Sometimes the revenue drop is significant and often the reduction in district expenses accompanying enrollment losses, in the aggregate initially, is far less than the amount of the revenue decline. Further complicating matters is the fact that district labor costs are largely determined by collective bargaining agreements that may be difficult to modify in the short run. The challenge for districts is to achieve a balanced budget without adversely affecting basic academic or other programs (e.g., gifted and talented, music, athletics, etc.) since this could lead to further enrollment losses and thus continued fiscal distress.

In addition to the challenges created by a finance system that relies so heavily on annual enrollment variations to determine total district funding, policy decisions have contributed to enrollment changes in many districts. In recent years, policymakers have expanded school choice options by allowing more and different educational service providers. These new policies offer students and families an important option to “vote with their feet” and flee schools that are perceived to be financially or academically failing. Motivated students and their families are no longer trapped in failing schools.

The per-pupil funding that districts receive from enrolling additional students is often greater than the marginal costs associated with providing educational services to these students, thus creating a financial incentive to compete for students. Competition among providers for students, especially in some urban areas of the state, is fierce and can result in substantial enrollment losses in a fairly short period of time. As students depart and take their funding with them to another provider, the school finance system does not provide any mechanism to cushion the immediate financial blow to the district that the student leaves.

Even in well-run school districts, managing declining resources caused by enrollment losses can be difficult. School districts face fixed (or semi-fixed) costs for building lighting and heating, employing teachers, and staffing ancillary school services (instructional support, transportation, administration, etc.). Gen-

erally, departing students are from all grade levels and, in larger districts, spread across multiple buildings, which creates challenges for school districts that have to respond by “managing down” to meet reduced resource levels. Thus, rarely can a district respond by closing a single classroom.

Other factors contributing to school financial troubles include poor financial management, frequent and disruptive turnover of key administrative staff, and poor leadership and oversight of district performance by elected district officials. In some instances, elected district leaders are unwilling to make the difficult choices to balance spending with available resources; while in other cases, leaders are simply unable to effect budget changes in a timely fashion because the size of an overall revenue drop can be quite severe and the major expenditure category (labor) is relatively fixed in the near term. Districts can use unrestricted reserves to help moderate significant revenue losses in the short run; however, they are unable to rely on these one-time resources as a long-term solution to chronic ongoing fiscal imbalance.

Numerous state laws and constitutional provisions are intended to prevent school district fiscal distress from occurring. These laws require certain actions of school officials and outline the oversight powers of the state, primarily the state treasurer but also the superintendent for public instruction. For example, the Uniform Budget and Accounting Act (Public Act 2 of 1968) requires that school districts enact and maintain balanced budgets and that no expenditure can be made without an appropriation. These provisions are intended to prohibit deficit spending by districts.

When districts do enter a deficit situation, the Michigan Department of Education takes on key oversight and monitoring roles to assist districts in moving out of deficit. Deficit districts are required to develop deficit elimination plans (DEP) and gain plan approval from the department. In most cases, plans must seek to eliminate the deficit within a two-year period, although the superintendent of public instruction can extend this period. It is noteworthy that throughout the DEP process, the state, while providing considerable technical assistance, cannot provide deficit districts with additional funds to help them solve their financial problems. Instead, local officials are required to reduce expenditures and adopt

management and budgeting reforms to eliminate a deficit. Many districts have successfully exited deficit status through the DEP process.

In general, the state, through various legal provisions, has attempted to provide a structure within which schools must operate financially. The state has provided broad financial oversight and it has attempted to provide a structure for assisting school officials to address problems that have led to fiscal distress. Despite these efforts, the state has not

been able to devise a perfect system that prevents fiscal distress from occurring.

Since 1990, the state has had a tool at its disposal to intervene in the financial affairs of school districts. Public Act 72 of 1990, the Local Government Fiscal Responsibility Act, incorporated the provisions of a previous state law that applied to general purpose local governments and extended the provisions, with some modification, to school districts. The state's basic authority under Public Act 72 to directly inter-

District Dissolution under the Emergency Manager Law

In the summer of 2012, the Muskegon Heights and City of Highland Park school districts were effectively dissolved; however, this occurred before the passage of Public Act 96. These dissolutions occurred under the state's emergency manager law (Local Government and School District Fiscal Accountability Act) in effect at the time.^a The state-appointed emergency manager of the two districts, as part of the financial and operating plans for the respective districts, converted both districts to new charter school systems and turned the delivery of educational services over to private entities. In effect, the emergency manager "charterized" the entire districts. The manager's actions dissolved the existing local public school districts, at least as educational services providers, and replaced them with entirely new "charter districts."^b However, unlike the most recent dissolutions under Public Act 96, the decision to dissolve the two districts was not based on an explicit state dissolution policy because such a policy did not exist at the time. Instead, these dissolutions were part of the manager's financial and operating plans.

Chartering an entire local school district provides an emergency manager with additional resources to satisfy debts. Specifically, the manager is able to use the proceeds from the 18-mill local school operating tax for deficit reduction.^c This is possible because of the financing mechanics of the state per-pupil foundation grant program; the per-pupil foundation grant for a "charter district" (just like the foundation grant for an individual charter school) is financed 100 percent from School Aid Fund dollars. Through this mechanism, an emergency manager is able to redeploy the annual local operating tax for deficit reduction. An emergency manager is able to repurpose the annual 18-mill tax without gaining approval from local electors, state lawmakers, or state officials (state treasurer or state superintendent of public instruction).^d

Because the per-pupil foundation grant for a school district converted to a "charter district" is financed entirely from a fixed pot of School Aid Fund dollars, fewer dollars will be available to distribute to all other districts in the state. Thus, the additional state funds used to replace local dollars for the per-pupil foundation grant in a "charter district" effectively result in a state authorized bailout at the expense of all other districts.^e

^a Both districts were under the control of a state-appointed emergency manager through the Local Government and School District Fiscal Accountability Act (Public Act 4 of 2011). Public Act 4 was overturned by state electors at the November 2012 general election and replaced by the Local Financial Stability and Choice Act (Public Act 436 of 2012).

^b The districts remain in existence as a legal entity for purposes of: 1) paying financial obligations; 2) levying and collecting taxes; 3) serving as a charter school authorizer; and 4) conducting school elections.

^c Both districts received loans from the Local Emergency Financial Assistance Loan Board in June 2012 to immediately liquidate their accumulated deficits and pledged the future proceeds from the local 18-mill school operating tax for loan repayment.

^d An emergency manager is able to use the 18-mill tax only until the authorization to levy the tax expires, at which time the manager may seek voter approval to reauthorize the tax if the district's deficit has not been eliminated.

^e Citizens Research Council of Michigan, *State Bailouts to Erase School District Accumulated Deficits*, CRC Memorandum No. 1113, June 2012.

vene to help address school districts' financial problems has continued through Public Act 4 of 2011 and now Public Act 436 of 2012, the Local Financial Stability and Choice Act.³ Significantly, both Public Act 4 and Public Act 436 extended increased authority and power to emergency managers to address local fiscal distress, including the authority to unilaterally modify or terminate existing contracts, suspend collective bargaining agreements, and transfer or sell assets, including closing schools and selling school property. Additionally, Public Act 436, and Public Act 4 before it, grants emergency managers authority for all district academic operations, which often play an important role in the development of fiscal distress.

Thus, for over twenty years and through three iterations of the same basic legal framework, state policy has allowed direct state intervention to address local school district fiscal distress in those isolated instances where preventative measures, including state oversight and the provision of technical assistance, have not deterred financial problems from developing. Under each version of the state's emergency manager law, the state government has not provided additional funds to schools to assist them with their financial problems. Instead, state law has consistently required that fiscal emergencies be addressed within the resources available by relying on spending cuts and implementing management and budget reforms. Two notable exceptions here in-

How Dissolutions Work under PA 96

Public Act 96 establishes a new procedure for dissolving an entire school district. The older method, which still exists, requires district dissolution when there are not enough people in a district qualified to hold office or willing to serve. Under the new method, a district would have to be dissolved if the state superintendent of public instruction and the state treasurer, after consulting with the intermediate school district (ISD) where the subject district is located, determine that all of the following conditions apply:

- The district was required to submit a deficit elimination plan and the district either failed to do so or does not have capability to implement the plan and deliver basic educational services;
- The district is deemed to be not financially viable ("Financially viable" means that a school district has the financial resources to carry out at least the educational program required by law and pay its existing debts as they become due taking into consideration the projected enrollment, cash flow, revenues, and borrowing capacity of the school district.);
- The district has an enrollment of at least 300 pupils and no more than 2,400 pupils;
- The district experienced an enrollment decline of at least 10 percent for the most recently completed school year;
- The district began the current school fiscal year in deficit and is projected to end the year with a greater deficit; and
- The district has not consolidated with another district in last 12 months.

If state officials determine that all of the above conditions apply, the ISD in which the school district is located, or the state superintendent of public instruction if the ISD requests, is required to dissolve the district and attach its territory to one or more other school districts. In deciding how to attach the dissolved district's territory (and pupils) to another district(s), the ISD or the state superintendent is required to take into account the number of students from the dissolved district and from the receiving district that qualify for free and reduced price lunch, receive special education services, and receive at-risk services. Within 60 days (21 days for districts dissolved in 2013), the dissolved district must account to its ISD for all records, funds, and property, and then make an equitable distribution of such to each receiving district.

If a dissolved district has outstanding debt, it is required to retain a limited separate identity and maintain a separate taxing unit for the purposes of levying a dedicated (i.e., previously authorized) debt service tax until the debt is retired or refunded. Also, the school operating millage (i.e., 18 mills on non-homestead property) would continue to be levied to repay the debts of the dissolved district. If the dissolved district levies a sinking fund millage, the ISD is required to levy the tax and distribute the proceeds of the tax to each receiving district that operates a school building of the dissolved district.

clude the 2012 conversions of two local public school districts (Muskegon Heights and Highland Park) to charter school districts. In these cases, the emergency managers took advantage of the mechanics of the per-pupil foundation grant program to gain access to additional resources to address the fiscal distress in the districts (discussed above).

As noted above, Public Act 96 of 2013 was enacted to address a subset of local school districts dealing with fiscal distress. This law represents another approach, separate from state's main vehicle for intervention, for the state to directly intervene in school

district financial affairs. The state's emergency manager law's primary goal is to rectify a local financial emergency without dissolving the governmental unit. Even under the municipal bankruptcy option allowed under the current emergency manager law, a school district will remain in existence before, during, and after the bankruptcy process. In contrast, the first step to address a financial emergency under Public Act 96 is to dissolve a school district, close its schools, and end its role as an education provider. In fact, the only thing that remains of a dissolved school district is its authority to continue to levy previously authorized taxes in order to satisfy outstanding debts.

Justifications for a New School District Dissolution Policy

Policy makers had a number of reasons for pursuing a new policy that would allow for state dissolution of school districts. The most apparent and pressing motivation for the new authority was the financial condition of a handful of school districts and concerns about their ability to deliver educational ser-

vices to their students. A less apparent rationale was the constitutional mandate that *state government* provide a free public K-12 education to all students. Other legitimate goals included protecting the state's credit worthiness and ensuring accountability for state taxes shared with school districts.

Charter Revocation for Academic Performance

While many traditional local school districts in financial distress also face pressing academic challenges, and poor academic performance may exacerbate fiscal distress, academic performance alone cannot serve as grounds for the dissolution of an entire local school district under Public Act 96. Persistently poor academic performance can lead to the closure of an *individual* school within a district; this intervention option is available to schools identified in the lowest achieving five percent of all schools statewide, called "priority schools". Alternatively, a "priority school" can be assigned to the statewide reform school district.^a Designation as "priority school" can involve considerable loss of local control over school management and governance issues.

In contrast, state law does authorize the state superintendent of public instruction to require the revocation (effectively a dissolution) of a charter for a public school academy because of poor academic performance.^b The Revised School Code requires a charter school authorizer to revoke the contract of a public school academy if it is notified by the state superintendent of public instruction that a public school academy that has been operating for at least four years; is currently in the lowest achieving five percent of all schools; and has not achieved Adequate Yearly Progress under the federal No Child Left Behind Act for six consecutive years (i.e., the school is in the second year of restructuring under the federal law). Upon receiving this notification, an authorizer is required to amend the charter of a public school academy to eliminate its authority to operate at the end of the school year. This action effectively dissolves the charter school by authority of the state superintendent. Although charter school authorizers almost always step in to take corrective action before such a dissolution, there have been limited instances where public school academies have been dissolved for academic reasons.

^a Michigan's statewide reform school district is the Education Achievement Authority. Currently, only 15 schools in the City of Detroit have been assigned to this district, representing a portion of the Detroit-based schools identified as the lowest-performing five percent of all schools in the state. Plans have been announced to expand the district to include schools outside Detroit in the future.

^b MCL 380.507(5)

Also, Public Act 96 may have been motivated by the state's recent policy goal to pursue the consolidation of government services or the wholesale merger of entire governments.

Fiscal Distress and the Ability to Deliver Educational Services

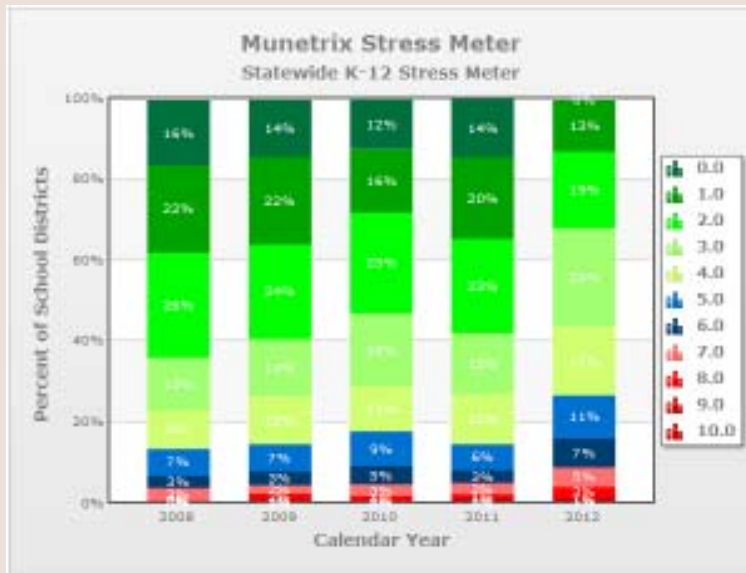
A primary justification for a policy to allow for state dissolutions of locally controlled school districts was the financial condition of certain districts. Lawmakers were prompted by the fiscal distress in a handful of districts and these districts' ability to deliver a full year's basic educational program.⁴ Specifically, the policy discussion was spurred when the Buena Vista School District was forced to close for two weeks in May 2013 after being unable to pay its employees.⁵ The district was able to reopen and complete the school year after the state released funding following approval of a deficit elimination plan. It is important to point out that while Public Act 96 was motivated by the immediate circumstances in a couple districts, the law is not limited to just these districts. Many more school districts are currently in fiscal distress and could potentially become subject to the dissolution process absent corrective actions.

Despite numerous statutory provisions to prohibit deficit spending, a growing number of districts are ending their fiscal years in deficit.⁶ The media's and the public's attention tend to focus on districts with operating deficits (approximately one in 10 local districts according to the Michigan Department of Education) because these districts represent those facing the most serious fiscal challenges at the present time. However, many more districts are challenged, and may be teetering on the brink of deficit.

The number of districts facing distress has been growing in recent years according to data compiled from school finance reports and analyzed by Munetrix.⁷ **Chart 1** shows the percentage of local school districts in each category of "fiscal stress;" districts with red shaded scores are the most stressed, followed by blue and then green. Since 2008, the bands of red and blue shaded districts have expanded while the green band has contracted.

The data presented by Munetrix is corroborated by information collected by the Michigan School Business Officials and contained in **Table 1**. It is clear that the fiscal strength of many districts is deteriorating. As the number of districts in deficit grows

Chart 1
Fiscal Health of Traditional School Districts in Michigan, 2008-2012



Source: Munetrix.com

Table 1
Number of Local School Districts by Fund Balance Amount: 2006-07 to 2011-12

	<u>2006-07</u>	<u>2007-08</u>	<u>2008-09</u>	<u>2009-10</u>	<u>2010-11</u>	<u>2011-12</u>
District Fund Balance as Percent of Revenue						
0% to 5%	56	57	63	73	44	50
5% to 10%	120	106	108	99	101	117
10% to 15%	114	114	119	131	127	136
Above 15%	237	249	231	211	237	199
Statewide Average	11.8%	10.8%	9.3%	7.2%	8.4%	9.0%
<i>Memo: Districts in Deficit</i>	21	21	29	36	41	47

Source: Michigan School Business Officials; Michigan Department of Education

(from 21 in 2006-07 to 47 in 2011-12), the average fund balance (measured as a percent of district revenues) for all districts statewide is declining.

The amount of unrestricted fund balance is one of the many measures of school district fiscal health and is considered a critical factor in financial planning and budgeting; however, there is no absolute “right answer” when it comes to the appropriate amount of reserves that a school district should maintain. The Government Finance Officers Association suggests that an appropriate level is 15 percent of revenues or expenditures. The final decision about the amount of fund balance is reserved for local school officials. In Fiscal Year 2013, the State of Michigan had unrestricted reserves in its rainy day fund of approximately 2.5 percent of total General and School Aid Fund revenue. The governor has stated that he would like to see the state build up its unrestricted reserves to an amount equal to six to eight percent of revenue.

The state’s decision to seek a policy whereby districts can be dissolved for financial reasons is intended to help avoid circumstances where struggling districts are forced, or threaten, to close before the end of a school year. Such early closures have been initiated recently, but avoided only because of extraordinary steps taken by state officials. Policymakers believe that empowering the state treasurer and state superintendent of public instruction to take preemptive action to close districts (before a new school year begins) will help avoid the disruption

that students and families must endure when their district effectively runs out of money in the middle of the school year and is unable to provide the required services. Public Act 96 was motivated by the belief that the state’s current processes for dealing with fiscal distress are inadequate and that state officials need additional tools to solve chronic problems.

Constitutional Mandate

The Michigan legislature’s interest in a new law allowing for school district dissolutions has its roots in the Michigan Constitution. The Constitution singles out education as a uniquely important government function by devoting an entire article to education (Article VIII). Maintaining and financing a public elementary and secondary education system is a state government responsibility under the Constitution. While state government discharges this responsibility through local school districts, it is the state that is ultimately accountable for providing students with K-12 education services. State government provides policy direction, funding, and oversight in pursuing this responsibility. The state’s responsibility for K-12 education rests with the legislature, the governor, and the independently elected State Board of Education (and the superintendent of public instruction appointed by the Board). The Michigan Constitution delineates various roles and responsibilities for each, but it entrusts the legislative branch with primacy with respect to public K-12 education.

Section 2 of Article VIII states that it is the legislature's responsibility to ensure that all children have access to a free public education. When financially struggling school districts are unable to provide the required services prescribed by law, the legislature must address such a void. While the State of Michigan has enacted a number of laws to prevent and react to school district fiscal distress, it had not adopted a policy to require district dissolution in those cases where financial recovery was not deemed to be a viable option. Granting the superintendent of public instruction and the state treasurer with the authority to dissolve districts and assign students to other districts is an extension of the legislature's constitutional responsibility to maintain and support a free K-12 public education.

Protecting the State's Credit Rating

Michigan has a long tradition of municipal home rule and local control of school districts. At the same time that the State of Michigan must honor these traditions, it has a parochial interest to ensure that fiscal problems of a single entity do not spill over and become a contagion for state government and other local governments. The state's interest is borne out of the fact that units of local government are considered creatures of the state; the state is ultimately responsible for these entities. The fiscal problems of local governments, if left unaddressed, can become problems for the state.

Fiscal distress may seem isolated and appear only to affect the school district experiencing trouble; however, the repercussions from a school district failing to make payroll, delaying or avoiding vendor payments, or missing scheduled debt service payments can reverberate outside a district's boundaries. The state's credit worthiness, as well as that of other districts, can be negatively affected when distressed districts fail to meet their financial obligations in a timely manner. For example, all districts might find it more expensive to borrow for cash flow purposes because of higher interest rates charged by purchasers of state-issued debt, such as the State Aid Note program. Potential investors could view *any* Michigan government debt as a riskier proposition, thereby demanding a higher return, if the state is unwilling to step in and help address the financial problems of local governments.

Accountability for State Taxes Shared with Schools

The state plays a major role in the finances of local government, delivering \$15.8 billion of state-sourced revenue to all types of local governments for multiple purposes. A significant portion of this amount, approximately 70 percent, is distributed to deliver public K-12 education. State revenues accounted for nearly two-thirds of the total revenue (state, local, and federal) available for school district operations in fiscal year 2012. State government has an interest in ensuring that the taxes it levies and collects are used in an efficient manner. Regardless of whether the taxes are used to finance services directly delivered by the state or passed along to school districts to deliver services, the state is ultimately accountable for the taxes it levies.

In being accountable for the taxes it collects, the state, therefore, has an obligation to be concerned about the fiscal health and operations of schools. A policy that allows state officials to dissolve school districts sheds light on the balance that state government must strike between honoring the traditions of local control of school districts and being accountable to taxpayers for the efficient use of state taxes for K-12 education.

Local Government Consolidation

Granting state officials the authority to dissolve financially struggling school districts also advances a goal advocated by many state policymakers: consolidation of local governments and/or the consolidation of local government services. For proponents of consolidation generally, the most common motivation to pursue consolidation of governments is to achieve economies of scale for local governments, which will lead to cost savings. School district consolidation advocates believe that district mergers will reduce costs by increasing the number of students served in a single district and spreading the fixed costs for school operations over more students. By doing this, the per-pupil cost of educating students declines. In addition to this primary justification for consolidation, other proponents support consolidation as a means to improve academic performance, provide additional educational opportunities for all students, and improve instruction.

Local government consolidation in Michigan has garnered significant attention in recent years, although actual consolidation experiences have been sparse. Governments have been more receptive to *consolidating services* and much less open to complete mergers. School districts have not been immune from policy discussions surrounding local government consolidation. A high profile merger took effect this school year when the Willow Run School District voluntarily merged with Ypsilanti Public Schools to create a new district, Ypsilanti Community Schools.

There are currently 549 traditional school districts in Michigan with student bodies ranging in size from the single digits to nearly 50,000. About one-third of the districts have fewer than 1,000 students. Given the ongoing fiscal challenges faced by many school districts across the state and the rare occurrence of voluntary consolidations, citizens, the media, and policymakers have asked whether the state should be supporting such a large number or relatively

smaller districts. Many have inquired whether smaller districts should be forced to consolidate into larger districts in the hopes of realizing economies of scale and achieving taxpayer savings.

Until recently, state policymakers have shied away from forcing consolidations. Instead, the state has taken steps to incent local school districts to consider consolidation, both complete *consolidation of governmental units* but also *consolidation of services*. State policymakers have used financial incentives to encourage local governments to pursue consolidations by making state funds available on a competitive basis to help with up-front and transition costs. Funds are available to help with service consolidation as well as unit mergers, but funding primacy is given to the merger of two or more local units. To some degree, the new district dissolution process of Public Act 96 is likely to advance the policy goal of reducing the number of school districts through forced consolidation.

Revisiting School District Dissolutions: Other Considerations

Clearly, the state's speedy development, consideration, and adoption of a new policy allowing for state dissolutions of local school districts was prompted by concerns over a few districts.⁸ The speed at which the legislation was enacted does not mean that policymakers were not legitimately concerned about these schools' abilities to provide K-12 services for the upcoming school year. On the contrary, the short amount of time it took to craft the new law suggests that lawmakers understood well, and took seriously, their responsibilities. As was mentioned above in the discussion of justifications for the new policy, it is the state government, not local districts, that is bound by a constitutional obligation to provide K-12 educational services.

It is possible that Public Act 96 was a policy response to a limited number of school districts and that this response was appropriate given the specific situations of the targeted districts. The fact that there are a number of specific conditions that have to be met to trigger a dissolution suggest that the new law could have been intended as a "one off" response; however, there is no guarantee that other similarly situated districts would not trigger the re-

sponse in the future. The authority for the state treasurer and state superintendent of public instruction to dissolve districts did not cease with the dissolutions of the Buena Vista and the City of Inkster school districts. For these reasons, this new authority must be understood in a broader context. Also, the limited public discourse and legislative deliberations surrounding the law's enactment did not address a number of issues that arose following the forced dissolution of these districts. Shedding light on these issues should help guide future decisions about dissolving school districts and the state's response to fiscal distress.

Local Approval for School District Reorganization

School district dissolution is one method for modifying school district boundaries. Other methods include consolidation, annexation, and property transfers (see box). While other methods may have the same end result as dissolution - one or more districts cease to exist - there is one key difference between dissolution and the other mechanisms. Dissolution is involuntary, while the other methods are voluntary.

All methods, except dissolution, require substantial local buy-in before reorganization can occur. The recent example of consolidating the Ypsilanti and Willow Run school districts into a new single school district sheds light on the important role local control plays in voluntary school reorganizations. The consolidation process involved considerable stakeholder input, approval by the affected school boards, and a popular vote of all electors in the new school district. The entire process took many months to complete. The new district dissolution process, on the other hand, only requires the state treasurer and superintendent of public instruction *to consult* with the intermediate school district in which the subject district is located. There is no prerequisite for local board or voter approval to initiate dissolution. In fact, the entire process can occur in a very limited amount of time. The new policy marks a departure from previous laws that require a local vote to alter school district organization.

Bypass Public Act 436

An important aspect of Public Act 96 is the fact that it allows state officials to unilaterally bypass the established processes that state government created

specifically for dealing with local government financial emergencies. Public Act 436 of 2012 (Local Financial Stability and Choice Act) establishes various review, reporting, notification, determination, and selection processes for dealing with local fiscal distress. Although state government drives the overall Public Act 436 process, local officials are afforded the ability to raise appeals at various junctures throughout the process. Also, in cases where the state determines a financial emergency exists, the local government has the power to select the option that will be used to address the emergency. In contrast, under Public Act 96, the state superintendent of public instruction is not bound by the deliberative PA 436 processes and is authorized to dissolve a school district after confirming that specific conditions are met and determining that a district is not “financially viable.”⁹

Currently, four Michigan school districts are operating under the authority of Public Act 436 (three have emergency managers and one is operating under a consent decree). Additionally, two districts are engaged in the review stages of Public Act 436 and it is not yet known whether a financial emergency exists in these districts.¹⁰ One of these districts

Methods of School Reorganization

Consolidation. Consolidation is a process used to merge two or more existing districts into a single new district. A request for a consolidation election can be made by the electors in each district or the local boards of education. The request is directed to the intermediate school district superintendent, who is then required to forward the request to the State Board of Education for its approval or rejection. The Board may approve the request or deny one or more districts from inclusion in the proposed consolidation vote. Board action is final.

Annexation. Annexation occurs when all or part of one district attaches another district to itself. The annexed district disappears and becomes part of a larger territory. Multiple districts can be involved in an annexation proposal, but each procedure is separate. The board of the annexing district must approve the annexation as well as a majority of the electors in the annexed district. The State Board also must approve a proposed annexation.

Annexation and Transfer. This process occurs when a portion of a district is annexed to a district and the balance of the annexed district’s territory is transferred to one or more districts. This process differs from annexation in that two districts receive part of the annexed district’s territory as opposed to a single district receiving all of the territory. The annexing district must receive at least 50 percent of the taxable value of the district being divided. Both receiving districts’ boards must approve the reorganization. Electors in the annexed district must approve as well. The state superintendent can approve or disapprove of the proposed division.

Dissolution. Prior to the enactment of Public Act 96, a school district could only be dissolved if there were not enough persons in the district qualified to hold office or who will accept the offices. Under this process, a district loses its organization and the intermediate school district board attaches the school district’s territory to another district or districts. The process does not involve a vote of district electors.

(Pontiac) originally was a target for dissolution under the proposed new policy; however, during the legislative process, an enrollment threshold was included to exclude schools with enrollments above 2,400 pupils and below 300 pupils (Pontiac has 5,195 pupils). In early August, just after Public Act 96 became law, the governor determined that a financial emergency existed in the Pontiac school district and a consent decree was agreed to as the option to deal with the district's financial emergency.

State Assumption of School Debts

The dissolution process effectively transfers the responsibility for financing a dissolved district's outstanding debts to all other districts in the state, including other financially strapped districts. Also, as a result of district dissolution, the State of Michigan has to shoulder the costs of financing the stranded retirement costs associated with the dissolved district's former employees. Because the state funds available for these costs will trickle in over a number of years as opposed to being immediately available to satisfy all outstanding debts at one time, the state will be paying for dissolved districts' financial problems for a number of years.

Under the dissolution process, the 18-mill non-homestead local school operating tax continues to be levied on property in the dissolved district despite the fact that the district is no longer educating students. The 18-mill tax is paid by businesses and second homeowners and is not levied on primary residences. The proceeds of the tax are normally used to finance the "local" portion of the per-pupil foundation grant. Under a dissolution scenario, the full yield of this tax is removed from the foundation grant and directed at deficit elimination and debt repayment. To make up for the "lost" local funding from the foundation grant program each year, the state School Aid Fund has to contribute more for the foundation grant of students from the dissolved district (who are attending other districts). For these students, the state funds 100 percent of their per-pupil grant until the dissolved district's debts are repaid. Thus, until all the debts are satisfied, an amount of funding equal to the 18-mill taxes in the Buena Vista and Inkster school districts is not available to other districts to finance their foundation grants or the vari-

ous categorical grants they receive (e.g., at-risk). Upon debt repayment, the 18-mill tax collected in the dissolved district is combined with the 18-mill tax collected in the receiving district and used to fund the foundation grant.

Repurposing the 18-mill tax for debt repayment in this manner works the same way as it does when an emergency manager "charterizes" an entire local school district. In both cases, the state assumes responsibility for eliminating school district debts. Clearly, state policymakers used the experience with chartering the Muskegon Heights and Highland Park school districts (discussed earlier) as a template for crafting this key aspect of the new school district dissolution policy.

The recent dissolutions illustrate the fiscal effects of using the 18-mill tax for debt retirement and not the foundation grant. According to the state, the Buena Vista and the City of Inkster school districts had accumulated deficits of \$1.0 million and \$12.8 million, respectively, at the end of 2011-12 school year (most recent data). The Senate Fiscal Agency notes that the total outstanding debts for these districts are \$3.0 million and \$18.0 million, respectively.¹¹ Thus, as a result of their dissolutions, approximately \$21 million will be diverted from the foundation grant program while the local school operating tax is used for debt repayment in these two districts over a number of years. As of October 2013, the tax generates \$1.6 million in the Buena Vista school district and just under \$1.0 million in the City of Inkster school district. Therefore, in the first year of debt repayment, about \$2.6 million in local school operating tax revenue will be diverted from the foundation grant program, requiring an equal amount of state aid to make per-pupil grants whole.¹² The Buena Vista school district's debts are estimated to be repaid in two to three years, but it will likely require at least 15 years to repay all of the City of Inkster school district's debts based on the projected yield of the 18-mill tax in that district.

Also, the responsibility for financing all of the unfunded retirement costs for former employees of a dissolved district are transferred to the state. Because of the current statutory cap on districts' contributions to the Michigan Public School Employee's

Retirement System (MPERS) for unfunded liabilities, the state will have to pick up a larger amount of the total annual unfunded retirement costs. The state will meet the increased obligation with School Aid Fund dollars, resulting in fewer School Aid Fund dollars for other districts in the state to share.

Thus, while it may appear that the accumulated deficits of dissolved districts are liquidated by taxes levied on property owners in the districts (i.e., 18-mill school operating tax), the actual mechanics of the state's new policy result in the state shouldering the burden for deficit reduction, either through the General Fund or the School Aid Fund.

As previously noted, the emergency manager law does not provide school districts with additional resources for dealing with distress, but Public Act 96 does. State government, through its adoption of this new policy, is signaling that some financial problems cannot be solved without the aid of additional funds. If this is the case, then it might be appropriate to provide these resources sooner, through the emergency manager process, rather than as a last resort (i.e., upon district dissolution). Providing these resources earlier in the process, but with strict conditions attached to their acceptance, could assist an emergency manager with implementing certain management and financial reforms required to address the distress and therefore stave off having to dissolve the school district.

Property Tax Issues Associated with Public Act 96

Provisions in Public Act 96 also raise a number of questions about the appropriate use of certain taxes. First, the law allows the proceeds from school taxes to be used for purposes not contemplated when voters originally approved the taxes. Second, by modifying how school taxes are used, Public Act 96 could result in the inequitable treatment of some taxpayers.

As discussed above, a key aspect of Public Act 96 that allows a dissolved district to address its fiscal problems is the authorization to continue to levy a school operating tax after it ceases operations. Using the 18-mill tax for deficit reduction breaks with the traditions of how Michigan has funded K-12 public

education. Since enactment of the Proposal A school finance system in 1994, the 18-mill tax has been exclusively dedicated to finance the foundation grant for operating costs in traditional public school districts. (As noted earlier, the foundation grant for charter schools has always been funded 100 percent by the School Aid Fund.) While state law has been changed to allow the tax to be used to eliminate previous years' deficits, it is unlikely that the local voters who authorized the 18-mill tax contemplated that the use of the tax would be changed after they authorized the levy.¹³

Using the local operating tax for deficit reduction could create inequitable treatment of taxpayers. This would result from timing issues related to gaining voter approval to levy the operating tax in order to eliminate a district's deficit. Under the law, authorization for the dissolved district to continue to levy the tax expires after its debts are retired or refunded. While the tax is being levied by the dissolved district for deficit reduction, the 18-mill tax levied by the district that absorbed the dissolved district (for the foundation grant) cannot be levied on property owners in the dissolved district.

Authorization to levy the school operating tax can only occur by a popular vote of registered electors in a school district and the expiration date for each district's levy is different. Districts commonly ask electors to authorize the tax for five to ten years. The different authorization expirations can create a situation where taxpayers in the geographic area of the dissolved district could enjoy tax relief for a period of time after the dissolved districts' debts are retired, but before the 18-mill tax is reauthorized by voters.¹⁴ While the school district absorbing the dissolved district can schedule a millage election to reauthorize the tax before the expiration of its current levy, this is not required under Public Act 96. In fact, the absorbing district, from a purely financial standpoint, would be indifferent to renewing the 18-mills since the state would continue to make up for the 18-mills not being collected from taxing property in the dissolved district. During this time, taxpayers in the dissolved district (primarily businesses) would be exempt from taxation, while taxpayers in the receiving district continue to pay the school operating tax. Thus, the new law has the potential to

contribute to the inequitable treatment of similar taxpayers for a period of time.

In addition to the 18-mill school operating tax, school districts levy sinking fund and debt taxes. Sinking fund levies are intended to cover the cost of building repairs, which may otherwise be financed from foundation grant revenues. Debt levies pay for bonded capital expenses, such as new buildings. Both of these taxes require voter approval and the authorization to levy them usually extends for a number of years (e.g., sinking fund taxes can be authorized for up to 20 years). Dissolved school districts that have authorized these levies must continue to tax until the authorization expires (e.g., debt is retired). Under Public Act 96, the proceeds of any authorized sinking fund levy are allocated by the ISD to each receiving district that operates a building previously operated by the dissolved district.

Taxpayers in a dissolved district could be forced to pay these taxes even if the capital stock of the district is mothballed because there is no requirement under PA 96 that a receiving district utilize the buildings it obtains from a dissolved district. In the case of the Buena Vista and City of Inkster school districts, students are attending schools of the receiving districts because the districts had excess capacity in their buildings to accommodate the influx of new students. While the funds from sinking funds may be used by the receiving district for its buildings, this was not contemplated by the voters when they approved the tax. Also, under a dissolution scenario, it is possible that taxpayers would have to pay the debt for vacant or nonexistent school buildings for years to come because authorization to levy these taxes often lasts up to 30 years. This creates a situation where taxpayers would be paying for capital facilities that are no longer in use or even owned by the jurisdiction currently levying the tax.

Other Options Not Necessarily Better

The students of a dissolved district that are assigned to a neighboring district to receive their education are not guaranteed to land in a district that has a significantly better track record, financially or academically, than their former district. While some students of a dissolved district will take advantage

of Michigan's education choice policies to find an alternative (another local district or a charter school) that is in better shape than their former district, not all families are in a position to avail themselves of this option. This will likely be a problem for those students that cannot access a district other than the one they are assigned to by their intermediate school district. For those students and families with the means to overcome barriers (e.g., transportation) to taking advantage of choice options, finding a better district and one that meets their educational needs may not be a problem.

The default process outlined in Public Act 96 requires an intermediate school district (or the state superintendent of public instruction) to assign students of a dissolved district to nearby districts. The law requires that decision makers take into account certain factors when determining where to assign students, such as existing enrollments, the number of low-income students, and the number of special education students in other districts. These factors may be important; however, equally important for the future success of the students being assigned is the financial condition and the academic performance of the districts under consideration. The law does not require the intermediate school district to consider whether a student's new district will be an improvement over his or her former district. It should be noted, however, that nothing prevents decision makers from taking other factors into consideration.

Following the dissolution of the City of Inkster school district in July, the Wayne Regional Educational Service Agency assigned Inkster's former students to the four contiguous districts – Romulus, Taylor, Wayne-Westland, and Westwood. Of the four receiving school districts, only Wayne-Westland is not currently on the state's deficit district list. From a financial perspective, none of these districts appear to be a significant improvement over Inkster. While their deficits may not be as large as Inkster's, the other districts may face other negative factors that are not entirely captured by a deficit figure. Should one of these districts continue to experience fiscal distress and be forced to dissolve at some point, Inkster's former students would be assigned to yet another district without any guarantee that this new district is in better financial condition.

Geography

The geographic size of Michigan local school districts varies considerably. The average district is 106 square miles with almost 112 students per square mile (median district is 72 square miles with approximately 20 students per square mile). Districts range in size from 1.5 square miles to 1,281 square miles. Student density ranges from less than 1 student per square mile to 1,471 students per square mile.

Given the variety among districts, geography should be a consideration in district dissolution; however, it is not. If a dissolved district's schools are mothballed because a receiving district has excess capacity in

its school buildings or its buildings are newer or recently updated, students from the dissolved district may find it more difficult and time consuming to get to school. For districts providing transportation services, this means that students will have to be on the bus for more time. If a receiving district does not provide transportation (to any of its students), some students may find it extremely difficult to access the school they are assigned to. Public Act 96 does not require district geography considerations to be taken into account as part of the decision to dissolve a district. Also, the law does not require an intermediate school district to take geographic factors into account when assigning the students of a dissolved district to a neighboring school district.

In Search of Policy Guidance

Significant fiscal distress is not a widespread problem among Michigan's 549 local school districts; however, it is evident that the financial condition of many districts has deteriorated in recent years in response to the combination of declining student enrollments, per-pupil funding cuts, rising retirement costs, and poor fiscal management. Because districts confront a semi-fixed cost structure, "managing down" operational expenditures to achieve a balanced budget has been a challenge for many districts. For some districts, these financial pressures and other factors have led to significant fiscal distress that necessitate direct state intervention. It must be acknowledged that the vast majority of districts, despite dealing with the same pressures and factors, have been able to maintain fiscal balance and deliver the academic program required by law. For those isolated districts deemed to be failing, academic failure can be a key contributor to and a resultant symptom of ongoing financial problems.

State government, which is ultimately responsible for public K-12 education, must be equipped with the policy tools to deal with those circumstances where preventative measures and policies are insufficient and when school districts fail financially. To this end, the state government has developed policies to deal with both academic failures (e.g., the Education Achievement Authority, the state's reform district) as well as financial failures (e.g., emergency manager statute). These policies involve direct intervention in local school affairs, including the pro-

vision of state-appointed officials, the requirement to adopt certain "reform" models, and the loss of some control to manage and govern local schools.

The adoption of Public Act 96 of 2013 allowing for state dissolutions of local school districts represents a break from the deliberative and participatory processes contained in the state's main legal framework (emergency manager law) for intervening in district financial matters. Until recently, the state had relied on the authority and powers contained in various versions of the emergency manager law to intervene in the fiscal affairs of local districts when certain conditions were met. Now, the state has what some might consider the ultimate tool at its disposal to initiate corrective action: the authority to unilaterally close schools and abolish local districts as a means to address school district fiscal distress. While the law ensures that the fiscal problems will be dealt with expeditiously, it does not guarantee that students will be placed in an educational setting that is significantly better, financially or academically.

It is possible that Public Act 96 was enacted as a "one off" response and that state officials have no intention of abandoning the emergency manager law as its preferred response to fiscal distress. In the development of this new law, state officials suggested that the emergency manager law was not an option for dealing with either the Buena Vista or the Inkster school districts. From this admission alone, it is clear that the emergency manager law is not a viable tool

in all cases. Only time will tell whether the state will invoke the dissolution process again, either in place of the emergency manager law or only after relying on the emergency manager law to intervene in school district affairs. It is also unknown whether the threat of dissolution in the future will prompt local school officials in struggling districts to enact necessary fiscal, management, and governance reforms to head off financial problems before they assume crisis proportions.

Local school districts, as creatures of the state, require consistent and transparent policy guidance from the state government concerning how it will deal with them if they should experience fiscal distress. The enactment of Public Act 96 signals that state policymakers continue to seek out policy guidance for dealing with fiscal distress. The state's ad hoc reaction for dealing with the unfortunate circumstances in the Buena Vista and Inkster school dis-

tricts illustrates that state government lacks a uniform model that it will apply when school districts fail.

Since 1990, the state had relied upon the statutory authority provided by the emergency manager statute to determine when and how to intervene in school district affairs. The adoption of a new policy allowing state dissolution of school districts raises a series of questions that require policymakers' attention. How will the state react to the next fiscal crises? Will state officials rely upon their existing powers and authority to intervene, or will another policy response be required? If school districts know that the state will step in with a "made-to-order" policy intervention that guarantees additional resources (at the expense of all other districts in the state) to erase past overspending and fiscal mismanagement, is the state incenting behaviors that its policies and safeguards are intended to deter?

¹ Public Act 436 is the fourth in a series of laws dating back to 1988 that have allowed for stronger state oversight of financially troubled local governments and intervention when necessary.

² See: *Funding for Public Education: The Recent Impact of Increased MPERS Contributions*, State Budget Note 2013-01, May 2013; *Distribution of State Aid to Michigan Schools*, Report 371, August 2011.

³ Public Act 4 of 2011 was rejected by voters through a state-wide referendum in November 2012. Public Act 436 of 2012 took effect in late December 2012 as replacement for Public Act 4.

⁴ Discussions during legislative deliberations of Public Act 96 specifically focused on the financial condition of three districts in particular; Buena Vista, Inkster, and Pontiac.

⁵ The state stopped providing state aid to the district when it was discovered that the state had overpaid the district for students no longer receiving services from the district.

⁶ Prohibitions are contained in the State School Aid Act (MCL 388.1702(1)) and the Uniform Budgeting and Accounting Act (MCL 141.436(7)).

⁷ Munetrix is a private company that aggregates various school fiscal and demographic data to provide a high level look at the fiscal health of individual school districts. The company has developed a proprietary fiscal scoring method based on certain financial ratios. Districts that receive lower "fiscal stress" scores are relative more fiscally sound than districts that receive higher scores. Scores are color coded with 1 through 4 shaded in green, 5 and 6 blue, and 7 through 10 red. www.munetrix.com

⁸ The legislation allowing for and implementing the school district dissolution process (House Bills 4813 and 4815) was in-

roduced on June 6, 2013, and signed into law by the governor less than one month later, on July 3.

⁹ The law defines this term as having "the financial resources to carry out at least the educational program required by law and pay its existing debts as they become due taking into consideration the projected enrollment, cash flow, revenues, and borrowing capability of the school district."

¹⁰ The four districts include Detroit (emergency manager), Highland Park (emergency manager), Muskegon Heights, (emergency manager), and Pontiac (consent decree).

¹¹ Public Act 96 requires that the 18-mill tax is used to satisfy all "outstanding debt," as that term is defined in the Revised Municipal Finance Act (Public Act 34 of 2011), plus any amount owed to the Michigan Public School Employees' Retirement Board.

¹² For Fiscal Year 2014, a General Fund appropriation (Public Act 97 of 2013) was made in the State School Aid Act to meet the increased state aid contribution needed to make the foundation grants whole.

¹³ Public Act 285 of 2012 changed the definition of "school operating purposes" to allow the 18-mill tax to be used for meeting deficiencies in expenses in "all preceding years" and repayment of emergency loans from the State of Michigan. Previously, the 18-mill tax could be used to satisfy deficiencies in expenses for the "immediately preceding year," in addition to its use for the per-pupil foundation grant.

¹⁴ The law is silent about a situation in which the 18-mill tax generates funds in excess of the dissolved district's debts. It does not speak to what would happen with the tax receipts after the deficit is satisfied, but before authorization to levy the tax expires.