CRC Memorandum

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State Assumption of School Debts

Introduction

On March 30, 2015, the Coalition for the Future of Detroit Schoolchildren (the Coalition) issued a report concerning the K-12 public education landscape and challenges in the City of Detroit.[1] The report contained a number of recommendations and calls to action, including many that focus on educational governance, choice, finance, and service delivery. The report is concerned with *all* schools in the city, both traditional public and charter public schools. Of particular note in the section of the report dealing with financial matters, is a recommendation for the State of Michigan to assume certain debts of Detroit Public Schools (DPS). According to the report, these debts are first-order financial challenges for the future of public education in the city. The implication is that they must be addressed whether DPS continues to operate as a stand-alone school system or as part of a larger system of schools in the city under a different governance structure (e.g., a portfolio district that includes Detroit-based public charter schools).

As of June 30, 2014, DPS had $299 million in long-term notes outstanding. These notes were originally issued in 2005 and 2011 to finance current spending, with the recent issuance done under the authority of the DPS emergency manager to address the district's accumulated operating deficit. The notes effectively converted short-term borrowings into long-term debt by extending the repayment period to 10-15 years. The Coalition is recommending that the State of Michigan directly assume responsibility for financing the annual debt service on these notes, which amounts to $1,100 per student, to allow these funds to flow into the classroom.

State assumption of this type of debt is not unprecedented. In recent years, the State of Michigan, through a couple different mechanisms, has assumed responsibility for financing the accumulated deficits of a few individual local school districts. In each case, a major shift in school governance accompanied the state's actions and the existing educational entity was eliminated. By taking on the debts of local districts, the state spreads the debt costs to all other taxpayers and school districts across the state. The situation in DPS is unique from previous state actions on at least two major fronts: 1) the scale of the debt involved; and 2) the uncertainties in how the state assumption of debt might fit into a larger financial and/or governance plan for addressing public education in the City of Detroit.

As state decision makers review and analyze all the recommendations put forth by the Coalition, any specific proposal for dealing with DPS's debts, whether as a stand-alone matter or as part of a larger vision for the future of education in the City of Detroit, can be informed by how the state has approached similar situations in the past. Also, much can be learned from the unintended consequences when the state has assumed the debts of financially struggling school districts. Most importantly, past experiences, along with the recent recommendation contained in the Coalition's report, suggest that 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 of state policymakers.

[1] Coalition for the Future of Detroit Schoolchildren, "The Choice is Ours," March 2015.

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What DPS Debts Are We Talking About?

It is important to clarify the debts at the center of the Coalition's recommendation because school districts across the state issue different types of debt and borrow money for various purposes each year. The Coalition is very specific about the debts that it wants the state to assume: debt issued to address the district's operating deficit, not its general obligation debt. It argues that this debt is the direct result of actions taken by state-appointed emergency managers tasked with addressing the district's financial problems and that DPS students should not bear the burden of the annual debt service payments. The district is on the hook for $53 million annually for the next five years, or about $1,100 per student this year, in principal and interest payments on this debt. These payments are made from the district's operating budget which is financed by its per-pupil foundation allowance.

The Coalition also recommends that DPS receive a financial reprieve from other financial requirements it is facing. It contends that the district should be exempt from making payments to the state-administered school employee retirement system for funding employee "legacy costs." In Fiscal Year 2013-14 (FY2014), DPS spent $71 million, the equivalent of $1,400 per pupil, to pay these costs. Funding to meet the employer-financed payments to the retirement system, including these "legacy costs," also are financed by the foundation allowance.

In total, the Coalition is asking the state to take on $124 million annually of DPS financial obligations for debt service and employee "legacy costs," nearly $2,500 per DPS student, as part of a plan to reconfigure public education in Detroit.

Current DPS Borrowing and Debt Outstanding

School districts engage in all types of borrowing every year. The intended use of the borrowed funds generally determines the type of borrowing used by districts. For example, school districts routinely issue long-term, general obligation debt to finance the acquisition and construction of major capital facilities and equipment, such as building and equipping a new school. This type of debt is often referred to as "full faith and credit" because the debt is backed by the general taxing and borrowing power of a district. This debt must be approved by the voters and is repaid from a special property tax levy (debt service levy). Repayment usually occurs over a number of years (typically 20 years) and annual principal and interest payments do not put pressure on the district's operating budget because the debt service is covered by a separate tax. However, they do increase the burden on district taxpayers.

At the end of FY2014 (June 30, 2014), DPS had $1.6 billion in general obligation debt outstanding. This debt was issued as far back as 1998 and as recently as 2010. All of this debt is "qualified" under the School Bond Qualification and Loan Program (see box on page 3). For the current fiscal year (FY2015), taxpayers in the district will pay 13 mills (one mill is equal to a $1 of tax for every $1,000 of taxable value) annually to finance $172 million (principal and interest) for the debt. Over the next 25 years, taxpayers will pay a total of $2.6 billion to retire the outstanding debt. The Coalition is *not* recommending that the state shoulder the responsibility for DPS's general obligation debt.

In addition to general obligation debt, many districts issue short-term notes to meet their cash flow needs throughout the school year. Because of the differences between the timing of receipts and outlays each month, districts sometimes need to borrow money to ensure they have sufficient funds on-hand when bills come due. Districts generally engage in cash flow borrowing early in the fiscal year (July 1) and must repay the full amount, plus interest, by August of the following calendar year. This type

State Assistance with General Obligation Debt

For purposes of issuing general obligation debt, many schools participate in a long-standing state program designed to provide access to the State of Michigan credit rating and certain credit protections. While the debt always remains an obligation of the local school district, the state shoulders some of the costs associated with districts' borrowings through this program.

The School Bond Qualification and Loan Program is created under the authority of Article IX, Section 16 of the 1963 Michigan Constitution and implementing statutes. The program allows districts to petition the state for "qualification" of its construction or refunding bonds. If granted, "qualified" bonds receive a credit enhancement (i.e., they may borrow using state's credit rating which means lower interest rates) and districts have access to state loans to help them meet the annual debt service requirements, assuming a minimum millage is levied.

The loan portion of the program allows participating districts to levy debt millage at rates lower than would be needed if they did not get their bonds "qualified." Per the state Constitution and statutory law, the State of Michigan is required to loan a district the amount of money needed to service the debt above what the district generates from its debt millage levy at the minimum rate. Currently, the state requires districts in this program to levy at a minimum seven mills and allows districts to borrow the funds needed above what is generated at this rate to make their annual payments. The state loans have to be repaid, with interest, by districts continuing to levy the minimum debt service tax rate over a prolonged period. If the state needs funds to make loans to districts, which it often does, it issues long-term general obligation bonds. These bonds represent an obligation of the state but do not require the approval of state voters per the state Constitution. Loans to districts are also made from a revolving loan fund administered by the Department of Treasury. This fund receives loan repayments from participating districts.

The loan program effectively transfers a portion of a district's *current* debt service costs to the state. Local taxpayers benefit from lower and more stable debt service levies; however, because of the loan repayment requirement, they end up paying the debt millage for a longer period of time. Also, because of the interest payments associated with the state loans, the overall cost of servicing debt on a local project can be higher than would have been the case without the state loan. The state's costs of the program are tied to the general obligation bonds that must be issued to finance loans to districts.

of borrowing does not require voter approval. The borrowing is not backed by the taxing authority of the district (i.e., debt service levy), but instead by specific pledged revenues; a portion of the per-pupil state aid the district receives for operations.

The State of Michigan offers a program to school districts that allows them to pool their cash flow needs to take advantage of competitive interest rates and lower borrowing costs. Under the State Aid Note Program (SAN), the Michigan Finance Authority issues short-term notes to generate the funds districts need. The participating districts pledge a portion of their state aid payments towards repayment. DPS routinely participates in the program, pledging its state aid to generate the funds it needs to meet monthly obligations. For FY2015, DPS has borrowed $108 million through the SAN Program. The Coalition is *not* requesting that the state take on responsibility for DPS's current cash flow borrowing.

Converting Short-Term Borrowing to Long-Term Debt

The Coalition recommends that the State of Michigan assume the funding responsibility for two series of long-term notes issued by DPS. In both cases, the notes were issued as part of plans to pay off the outstanding balances of cash flow borrowings.

In October 2011, as part of the DPS emergency manager's plan to address the operating deficit, the district refinanced the outstanding balance of its cash flow notes (SAN) that were due on June 30, 2011. The district had borrowed a total of $420 million during the fiscal year for its cash flow needs with repayment due within 12 months; however, the district was unable to repay some of the notes with existing resources in the time allotted. In order to avoid a default, the emergency manager authorized the district to issue $231 million in 10-year bonds to cover the original borrowing. He effectively converted the district's short-term borrowing to long-term debt.

The 2011 debt was issued through the state's Michigan Finance Authority with repayment pledged from the district's state aid. Basically, as a type of limited tax general obligation bond that did not require voter approval, the bonds carry an interest rate of 4.75 percent with full repayment scheduled for 2021. The total interest cost on the debt is estimated at $66 million and the annual debt service is $32 million in the current year. This borrowing had the effect of reducing the district's accumulated year-end operating deficit from $284 million at the end of FY2011 to $83 million at the end of FY2012.

The 2011 debt was not first time the district converted short-term debt to long-term debt. Years earlier, DPS was unable to repay the funds it borrowed to meet cash flow needs throughout the year. In April 2005, the district was allowed to refinance $210 million in short-term notes (SAN) outstanding as of June 30, 2004, as a way to pay off its previous borrowing and eliminate an operating deficit in its General Fund. To do this, the district issued special purpose bonds payable over 15 years. This action converted the short-term borrowing to a long-term debt. The plan required the debt service payments to begin in 2007 ($16 million in 2007 and $22 million each year after) and for the debt to be fully repaid by June 2020. This borrowing was part of the district's multi-year deficit elimination plan approved by state officials in February 2005. The district, at the time, was under the control of the mayoral-appointed school reform board created under Public Act 10 of 1999.

By the end of FY2011, DPS still had $141 million of the original $210 million 2005 special purpose bonds outstanding; however, the district was now under the control of the state-appointed emergency manager. The emergency manager, in May 2012, refinanced the remainder of the original special purpose bonds by authorizing the district to issue $141 million in long-term notes, thus taking advantage of lower interest rates. This refinancing maintained the original final repayment date of June 2020.

With the debt issued in 2011 and 2012, DPS has been allowed to extend the repayment of its cash flow borrowing well beyond the year in which the borrowed funds were used to support school operations. At June 30, 2014, the district had a total of $299 million in long-term notes outstanding. This is essentially money borrowed for operations (i.e., deficit reduction) in previous years. Debt service on this limited general obligation debt is paid from current operating funds (i.e., per-pupil foundation allowance), which would otherwise be available for services, including employing teachers, purchasing books, and maintaining buildings. This debt raises concerns over intergenerational equity; requiring current and future students (through reduced per-pupil spending) to finance the educational services delivered to previous students.

The annual cost for servicing the 2011 bonds and the 2012 notes (originally the 2005 bonds) is $53 million through FY2019. Based on current student enrollment (roughly 48,000 students), this amounts to about $1,100 per student that the district has to cover primarily from its per-pupil foundation allowance. The debt service is structured as a fixed amount. With the expected continued enrollment decline in DPS, the per-pupil cost will be slightly over $1,200 by FY2019.[2]

Converting short-term borrowing to long-term debt is not a common practice among other districts in the state. In fact, it has been done only one other time. In 2013, the Michigan Finance Authority issued $19 million in revenue bonds to pay off the outstanding cash flow borrowings of two districts (School District of Ypsilanti and Willow Run Community Schools) that consolidated their operations beginning with the 2013-14 school year. In order to provide the newly formed district, Ypsilanti Community Schools, with a clean slate and eliminate the inherited General Fund deficit, the state issued long-term debt in August 2013 to pay off the outstanding debts. Like the DPS debt, the annual debt service is financed by current state aid payments the Ypsilanti Community Schools receives. However, the Ypsilanti debt service is far less (approximately $370 per pupil in the current year and about $525 per pupil in future years) than the DPS debt service ($1,100 per pupil for current year).

[2] DPS's current deficit elimination plan projects an enrollment decline of 10 percent from FY2014 to FY2018, before enrollment remains constant.

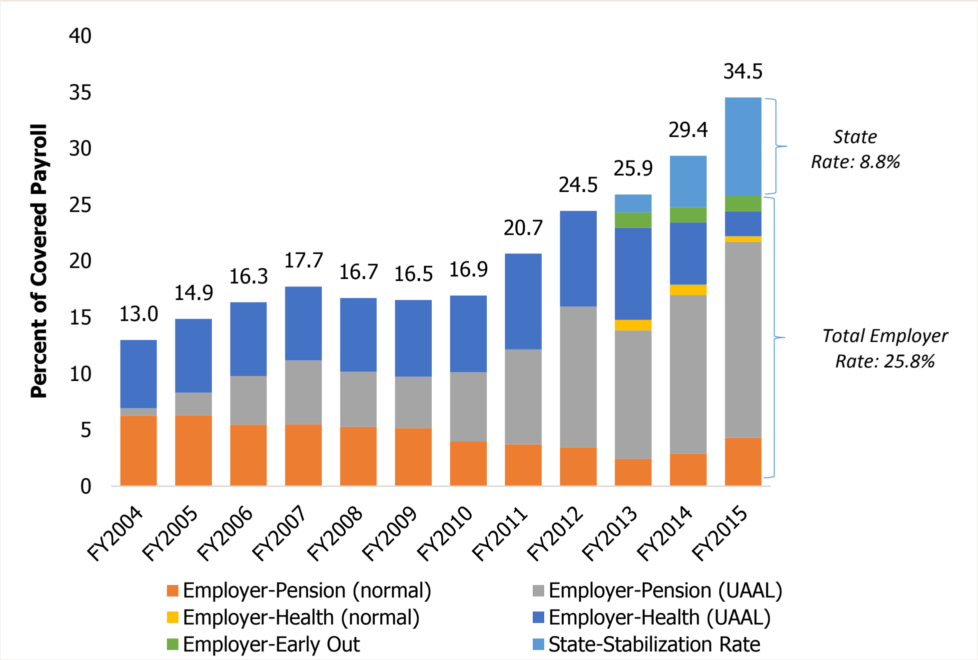
Michigan's Pooled Retirement Program for Education Employees

The Michigan Public School Employee Retirement System (MPSERS) provides retirement benefits for covered employees of public school districts and community colleges, as well as certain public school academies, state universities, and public libraries. The system provides both a financial pension benefit, as well as health, dental, and vision insurance benefits for eligible retirees. The cost of providing these benefits is shared by employers and employees that participate in the system. Employer contributions to meet estimated retirement costs are determined by the Michigan Office of Retirement Services on the basis of an annual actuarial valuation of the retirement system's assets and accrued liabilities. The estimated cost is then charged to employers (school districts, etc.) on an annual basis as a percentage of payroll for employees covered under the system.

The annual employer contribution rate charged to individual school districts is comprised of three component categories: 1) pension normal costs (the cost of future benefits attributable to the current year of service); 2) retiree health normal costs; and 3) unfunded actuarially accrued liabilities (UAAL) for both the pension and retiree health benefits. This last component is commonly referred to as employee "legacy costs" and results when the previous amounts collected to cover the normal costs are not sufficient to cover those benefits in the future. When the assumptions used in setting the annual contribution rate are not met, UAAL result for the system. Since employee contributions are fixed in statute, these unfunded liabilities must be covered through additional employer contributions.

Chart A presents the employer contribution rate, by major component, from FY2004 to FY2015 (current year). Additionally, because of reforms to the retirement system intended to cap the employer share of UAAL, the State of Michigan is responsible for UAAL payments that exceed 20.96 percent of covered payroll; this contribution amounted to 8.8 percent of payroll in FY2015.

Chart A
MPSERS Employer Contribution Rates, FY2004 to FY2015



Source: Office of Retirement Services

Of particular note in **Chart A** is the growth in the UAAL components, the result of lower-than-anticipated investment returns for system assets. In FY2004, the combined UAAL contribution rate for both pension and retiree health was 6.73 percent of payroll. In FY2012, when the employer cap was instituted, the UAAL rate had increased to 20.96 percent of payroll. Because of the system reforms in 2012, the employer UAAL rate is capped at 20.96 percent each year. Over the same period, the combined normal cost fell from 6.26 percent of payroll for FY2004 to 3.47 percent of payroll for FY2012. Thus, it is the increased employer contributions for "legacy costs" that are driving the retirement funding challenges for school districts.

Legacy Costs

In addition to help with meeting the annual debt service obligations, the Coalition has recommended that the state to pick up a portion of DPS's annual contribution to the school employee retirement system. The Coalition posits that the financial requirements of the retirement system divert operating funding away from current students enrolled in Detroit schools. The Coalition argues that because the system is managed by the State of Michigan the financial challenges are the result of state decisions. Therefore, the Coalition recommends that the state assume all of the funding responsibility for employee "legacy costs." Specifically, it would like the state to pick up DPS's nearly $71 million annual contribution.

It should be noted that all traditional public schools are required to participate in MPSERS and that the funding challenges arising from the growth in "legacy costs" are not unique to DPS. MPSERS is a multiple employer defined benefit system that effectively shares the system's funding responsibilities across all school districts in the state. Costs to individual school districts to meet required payments are shared according to a district's portion of the total active payroll. Employer contributions are expressed as a percentage of payroll, thus those districts with more employees contribute more, in nominal terms.

While DPS has more employees covered by the system because of its size relative to all other school districts, it also has experienced the largest decline in active employees in the system as staff sizes have been reduced in accordance with declines in the number of students attending Detroit Public Schools. In FY2007, DPS had 15,800 employees covered by the system, approximately 5.4 percent of all employees in the system. For FY2013, its employment level had dropped to 9,118 employees (4.2 percent of the total). This decline has allowed the district to reduce, in nominal amounts, its contributions to the system from $137 million in FY2007 to $84 million last year, despite the fact that the system's unfunded pension liabilities increased from $5.8 billion (FY2007) to $25.8 billion (last year) over the same period. DPS is far better off under the current system where the costs of funding MPSERS are shared with all other participating school districts than it would be if it operated a stand-alone pension system like most cities in Michigan do.

Table 1 shows the history of DPS total contributions to MPSERS, including the share dedicated to finance "legacy costs." These costs increased by $1,000 per

Table 1
DPS Covered Wages, Retirement Contributions, and "Legacy Costs" per Student, FY2004 to FY2014

Fiscal Year	Covered Wages (millions)	MPSERS Contributions: Total (millions)	MPSERS Contributions: "Legacy Costs" (millions)	Number of Students	"Legacy Costs" per Student
FY2004	$948.2	$123.2	$63.8	150,415	$424
FY2005	$803.1	$126.1	$68.7	141,406	$486
FY2006	$756.5	$123.0	$82.2	131,568	$625
FY2007	$777.7	$137.3	$95.2	114,401	$833
FY2008	$794.2	$132.9	$90.9	102,494	$886
FY2009	$689.3	$114.0	$78.4	91,827	$853
FY2010	$598.3	$101.2	$77.5	88,218	$879
FY2011	$490.3	$100.1	$83.0	77,594	$1,069
FY2012	$453.2	$108.2	$95.1	70,326	$1,353
FY2013	$335.0	$82.4	$70.2	50,172	$1,399
FY2014	$340.1	$83.9	$71.3	49,870	$1,429

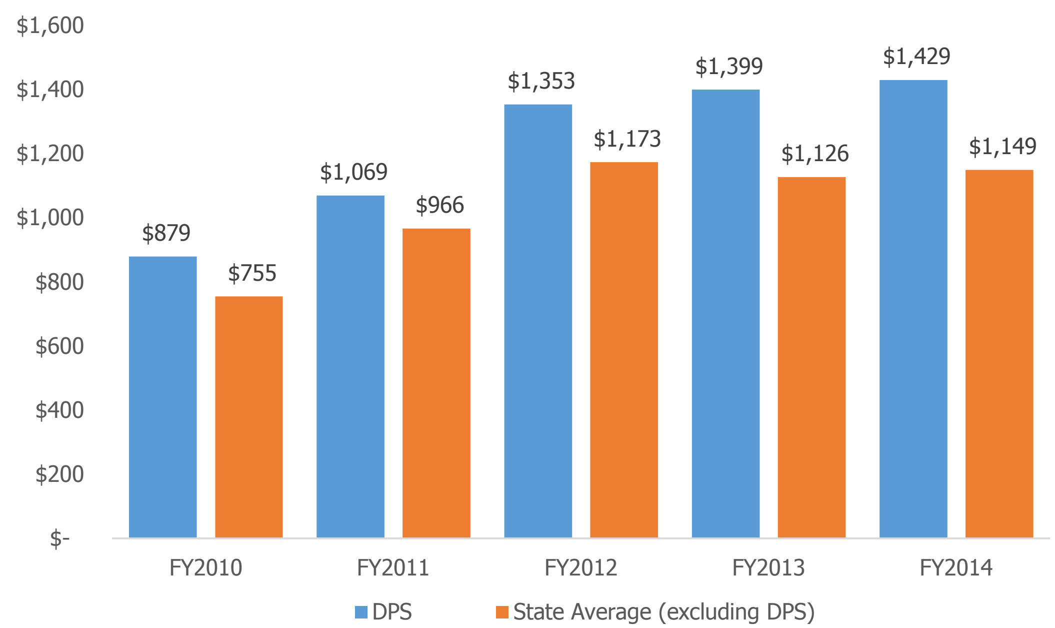
Source: Office of Retirement Services; Michigan Department of Education pupil between FY2004 ($424 per pupil) and FY2014 ($1,429 per pupil). This sharp increase followed the rapid rise in the employer retirement contribution rate over the period (noted above). Since FY2012, the per-pupil contribution has stabilized with the district's UAAL payment capped at 20.96 percent of payroll. DPS contributions to MPSERS, including the share dedicated to finance employee "legacy costs," are financed from the district's per-pupil foundation allowance. The district's foundation allowance in FY2014 was $7,246 per pupil, up from $7,180 in FY2004. However, because the district's "legacy costs" contribution increased by $1,000 per pupil during the same period, the small foundation allowance increase has been completely eroded and additional foundation dollars are needed to finance the retirement contribution. This leaves even fewer foundation dollars available for other spending, including basic classroom instruction.

All school districts participating in MPSERS have experienced similar pressures from escalating "legacy costs" contributions. The amount of a district's per-pupil contribution is a function of many variables, including the total system UAAL, the district's covered payroll, and the district's enrollment. As shown in **Chart 1**, DPS's annual per-pupil contribution is significantly greater than the per-pupil contribution for the remainder of public school districts in the state, on average. In FY2010, DPS's contribution was $124 per-pupil greater than the statewide average. Since that time, the gap has grown to $280 per pupil. This is largely explained by DPS's substantial enrollment loss in recent years; relative to other districts, DPS enrollment has declined at a faster rate than the reduction in its payroll.

DPS's Operating Deficit

The district has spent more money than it received in its General Fund in eight of the nine previous fiscal years dating back to FY2006 (See **Chart 2**). This repeated overspending contributed directly to a precipitous decline in the district's year-end General Fund balance; it went from $20.6 million (FY2006) to negative $284 million (FY2011) in a very short period. The situation with the General Fund only improved on paper because of the borrowing mentioned above (i.e., converting short-term debt to long-term debt). After issuing the debt in 2011

Chart 1
Detroit Public Schools Per-Pupil Contributions for "Legacy Costs", FY2010 to FY2014



Source: Office of Retirement Services

Chart 2
Total General Fund Revenue, Expenditures, and Year-End Balance: FY2005 to FY2014

Source: DPS, Annual Financial Reports

and using the proceeds to pay down the year-end deficit, the General Fund operating deficit reduced from $284 million to $83 million. Since that time, the General Fund deficit has more than doubled to $172 million as of the end of FY2014. While the district was able to buy itself more time to pay back the short-term notes used to finance current operations and, in the process, reduce its General Fund operating deficit, the consistent overspending has added to the General Fund's negative position.

Closing the district's General Fund deficit draws away funds received annually to support current operations. In essence, funding allocated for current students' educational services have to be used to pay for services delivered to students in past years. A handful of school districts in recent years have received state assistance to pay down their operating deficits in an attempt to maintain funding levels for current students' education (discussed below), but, at this time, the Coalition is not recommending that the state provide direct assistance to pay down DPS's deficit. It should be noted, however, that the state financial support requested by the Coalition would effectively free up funds to allow the district to address its operating deficit.

Taking on the Debts of "Charterized" and Dissolved School Districts: What Have We Learned?

In recent years, the State of Michigan has assumed the debts of a handful of financially failing school districts by effectively providing these districts with additional state funds to liquidate their operating deficits. As the state works to ensure that the debts in financially struggling districts are settled in a timely manner and that the school children receive the education they deserve, its actions to date can provide helpful lessons for dealing with the immediate request from the Coalition for the Future of Detroit Schoolchildren. Any state response to deal with DPS debts will likely draw upon solutions used in these other districts, keeping in mind that the Detroit situation is complicated by two critical issues: 1) the scale of the debts involved; and 2) the uncertainties in how the state assumption of debt might fit into a larger financial and/or governance plan for addressing public education in the City of Detroit.

Some Problems Require More Resources to Solve

The current state laws for dealing with financially troubled school districts do not allow for additional resources to be provided to the districts. The underlying assumption is that current resources are sufficient and better financial management will cure each school district's financial troubles. Under the deficit elimination plan (DEP) process, financial problems are to be addressed within the current resources available to the district. Similarly, the Local Government and School District Fiscal Accountability Act (Public Act 4 of 2011) does not contemplate the provision of additional funds as a solution to resolve a district's financial challenges.

Despite these prohibitions against providing failing districts with additional resources from either state or local sources, four school districts have received additional aid to address their operating deficits since 2012: the Muskegon Heights School District (2012), Highland Park City Schools (2012), the Buena Vista School District (2013), and Inkster Public Schools (2013). In each case, district officials showed little success in addressing the underlying financial problems or eliminating the operating deficits. Two districts, Muskegon Heights and Highland Park, were under the control of an emergency manager. The other two districts, Buena Vista and Inkster, were under the control of locally elected school boards. All four districts were operating under DEPs required by The State School Aid Act of 1979. As a result, the state stepped in to deal with the finances.

Through the plans crafted for eliminating each district's debts, state policymakers have acknowledged that some problems plaguing districts cannot be adequately addressed within the current funding allotted to them and that additional financial resources, and time, may be necessary. Declining enrollment, and the resulting declines in annual revenue, in each district contributed to the financial challenges and deficits, but it also made it difficult for school boards or emergency managers to stabilize finances and eliminate deficits without additional outside funds.

The fiscal problems in these four districts, at least in nominal dollars, are dwarfed by the scale of the current problem facing DPS. Consider, for example, the operating deficits as a measure of the financial stress in each district. At the time that state assistance was provided to the Muskegon Heights School District and Highland Park City Schools in 2012, the two districts had General Fund operating deficits of $12 million and $9 million, respectively. As of June 30, 2014, DPS's operating deficit was $172 million, nearly eight times larger than the *combined* deficits of the two districts. The district's finances have been controlled by an emergency manager since 2009, and the deficit has increased each of the past three years. It is worth noting that relative to the overall size of each districts' operations, the problem in DPS is much smaller. The 2012 deficits in Muskegon Heights and Highland Park equated to 70 percent and 52 percent, respectively, of annual operating revenues. In contrast, the 2014 General Fund deficit for DPS was 24 percent of operating revenues.

Regardless of the metric used, the bottom line for policymakers contemplating the financial challenges in DPS is the fact that this may be another instance where additional resources, in some form, are needed. Despite financial interventions, including the issuance of long-term notes to pay down the deficit, emergency managers have been unable to stabilize the finances and address the district's growing operating deficit with the resources currently available.

Repurposing the Local School Operating Tax

In all four districts where the state intervened, the funds for deficit elimination were provided by the same source: a repurposed local school operating tax. Given policymakers' approval for using this tax for debt reduction, it is likely that it will play a part in any response to address DPS's debts.

By law, the 18-mill school operating tax is levied on non-homestead property (primarily business property, rental property, and second homes) and dedicated to finance the local portion of a district's per-pupil foundation allowance. Revenue from this local tax plus money from the School Aid Fund (SAF) provide the funds to meet the district's state-determined foundation allowance amount.

As part of their plans to address the academic and financial problems in the districts, the emergency managers in Muskegon Heights and Highland Park converted both school districts to public charter schools. Educational services were farmed out to private providers under contract with the new charter school district. Because charter schools, by law, cannot levy taxes, these two "charterized" districts could not levy the 18-mill tax. Therefore, by law, the per-pupil foundation allowance for students attending charter schools is financed entirely by SAF dollars. The conversion of these districts freed up the local tax revenue, which the emergency managers put towards paying down the districts' deficits.[3] The original districts remained in existence, under the control of the emergency manager, only for purposes of levying taxes.

In a similar way, the 18-mill tax is being used to pay off the debts of Buena Vista and Inkster school districts. In this instance, the two districts were dissolved under a state law passed in 2013 and their former students reassigned to attend neighboring school districts. The new law keeps the dissolved school districts intact for legal purposes only to levy the 18-mill local school operating tax to pay off those districts' debts.

The state's experience with these districts has had its share of challenges. For example, in the now-dissolved Buena Vista School District in Saginaw County, authorization to levy the 18-mill tax used for debt retirement expired and voters rejected renewal of the tax in November 2014. The expiration of the tax eliminated the planned funding mechanism to pay off the district's debts. This sent state officials back to the drawing board to determine how to liquidate the deficit. At this time, a final solution to the Buena Vista debt situation is still pending. State officials continue to grapple with the consequences, both intended and unintended, arising from the Buena Vista school district dissolution and from the experiences in other districts where the state has assumed certain debts.

While the methods to arrive at the deficit elimination solution in the two districts were very different, the financial effects of the Muskegon Heights School District and Buena Vista School District cases were exactly the same; local funds are removed from the overall school operational funding mix and replaced, dollar-for-dollar, with an equal amount of state SAF funds. This means that there are fewer SAF resources each year available to provide to all other school districts in the state. In the four districts where the 18-mill tax is being used for debt relief, the total yield from the tax in the current year is estimated at $5.4 million. This means that $5.4 million in SAF dollars will be used to make whole the foundation grants for students from these communities (approximately $4 per pupil fewer state dollars to share with all other districts across the state). The 18-mill tax will continue to be used for debt relief until all district debts are repaid, which can be a number of years depending on the initial debt amount and the annual tax yield. It is only after a district's debts are repaid that the funds from the tax are used to finance the foundation allowance for students in the community, as originally intended.

[3] Citizens Research Council of Michigan, "State Bailouts to Erase School District Accumulated Deficits," Memorandum No. 1113, June 2012. http://www.crcmich.org/PUBLICAT/2010s/2012/memo1113.pdf

For DPS, the 18-mill tax yields $72 million in the current year. If the full amount of the tax was shifted from supporting the foundation allowance to instead being used to help with the district's debts, $72 million in replacement SAF revenues would be needed to maintain the per-pupil funding level. That would result in the loss of approximately $50 per pupil in state dollars to share with all other districts across the state.

So while the use of the 18-mill tax appears to be a "local" solution to school district debt relief, it is undeniably a state-financed solution. This is because the foundation allowances for the students of these districts (or former students in the case of dissolved districts) are not reduced with the removal of the 18-mill tax receipts from the overall school funding mix, thus the SAF's burden is increased. This increase comes at the expense of fewer state dollars being made available for other students across the state, either through the general foundation allowance or in categorical grants aimed at specific student groups.

Changing the Governance Model

In each of the four cases, the provision of additional state funds was contingent on state-mandated changes to the governance structures of these districts, effectively ending the status quo systems. The state used two different models to modify the governance structures. In the Highland Park and Muskegon Heights school districts, the emergency managers "charterized" all the schools in the districts. To this end, the emergency managers created new public school academy systems that are responsible for providing educational services to the residents in each community. The systems, run by boards that are appointed by the emergency managers, contracted with private management companies to deliver services. Unionized teachers of the Muskegon Heights and Highland Park districts lost their jobs and were given the opportunity to apply for positions within the private management companies.

The emergency managers retained the traditional public school district as legal entities, but not as an educational provider. The traditional districts remain intact for purposes of levying taxes needed to pay off debts, specifically the 18-mill local operating tax and dedicated taxes for bonded debt. The emergency managers' unilateral power to "charterize" an entire district and appoint a new governance board lies within the state's emergency manager law. Under this school governance model, the locally elected school boards basically exist in name only and retain no power over operational or financial matters.

In contrast, the change in governance structure for the Buena Vista and Inkster school districts came as a result of a new state law. Public Act 96 of 2013 allowed state officials to dissolve certain financially struggling school districts. The new law took effect in the summer of 2013, before the start of the 2013-14 school year. Pursuant to this law, the boundaries for surrounding school districts were redrawn to encompass the territory formerly served by the Buena Vista and Inkster districts and students residing in those territories were reassigned to those surrounding districts. The new law requires a dissolved school district to continue to exist solely for the purposes of paying down its debt. The dissolved district is required to continue to levy all authorized taxes until its debts are settled, subject to voter authorization. The change in governance structure is a complete elimination of the school district as an educational service provider.

What governance changes may, or may not, accompany any additional state funds to help with DPS's debts are unknown at this juncture. Community leaders in Detroit are calling for significant changes, while Governor Snyder has signaled that he will offer recommendations in the coming weeks about the future of public education in Detroit. His recommendations are likely to go beyond the DPS's financial problems, to include governance and accountability reforms.

The challenge in Detroit vis-à-vis the other districts is the complexity of the educational landscape in the city. Detroit does not have a single school system, but instead many disparate, and competing, *systems*. The city is home to DPS and its nearly 100 schools, almost 100 public charter schools authorized by many different authorizers, and the 15 schools under the Educational Achievement Authority. The Coalition for the Future of Detroit Schoolchildren has recommended creation of a single, unified system in the city; a portfolio management system that includes all schools (DPS, charter, and EAA). The mayor would serve as its chief executive officer. However, this represents only one potential model.

A Policy for State Assumption of School Debts

In many respects, the experiences of the Buena Vista, Inkster, Highland Park, and Muskegon Heights school districts served as the proverbial "canary in a coal mine." While DPS is currently the most recent financially and academically struggling district requesting direct state assistance with its debts, 55 other school districts across the state began the current fiscal year in a deficit situation. A request from any one of these districts, some of which are under the control of state-appointed emergency managers, may not be too far off. If nothing else, the experiences to date yield two clear conclusions: 1) policymakers have accepted the premise that some financial challenges facing school districts cannot be solved within existing resources and additional funds and/or debt relief may be needed specifically to address some legacy costs; and 2) the State of Michigan lacks a clear and consistent policy related to the assumption of school debts.

Before dealing with the immediate situation involving DPS debts and in anticipation of future requests for state assistance, policymakers should give consideration to the larger question raised in this report about the lack of a long-term policy. Formulating such a policy should be a top priority of state policymakers. In developing a policy, the state must be cognizant of criteria such as transparency, fairness, accountability, and consistency.

Because only select school districts will benefit from state assistance with school debts and legacy costs, it is important that the policy is transparent. This includes everything from the identification of eligible districts to the determination of the amount of assistance provided. It should be clear to all why the help is needed in the first place and why alternative solutions to the district's problems are inadequate. This should be spelled out in law and the financial resources should originate from an appropriation authorized by the legislature.

A fair policy attempts to assign responsibility and costs, financial or otherwise, to the district receiving assistance. While a direct bailout without any "strings attached" might be the preferred solution, this would not be fair to all other districts in the state, especially if they are responsible in some way for the financial burden that comes with state assumption of debt. Bailouts of this sort set a poor precedent for dealing with future situations. At a minimum, a district receiving state help with its debts or legacy costs should be responsible for shouldering some of the burden, either through existing resources or from an additional tax levied on taxpayers in the community. An equitable policy demands restructuring of district finances and organization, and, almost certainly, governance.

State assumption of school debts must accompany both governance and administrative reforms to ensure accountability, both in the short- and long-term. 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 if there is a strong indication that they would lead to insolvency in the future. The district must be prohibited from using long-term borrowing to cover current operational expenses. Ultimately, policymakers must ensure that the policy is crafted to foster public confidence that struggling districts do not return asking for additional state help 5 or 10 years down the road.

Finally, a policy must be consistent in its application for similar circumstances. To date, the state has relied on ad-hoc responses to help districts with their debts. A policy couched in state law should not discriminate based on geography, district size, or student population.

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