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Knowledgeable Navigation to Avoid the Iceberg:

Considerations in Proactively Addressing School District Fiscal Stress in Michigan

MSU Extension White Paper

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School districts in fiscal crisis are highly unlikely to provide educational environments in which students learn, grow, and thrive; yet in Michigan, 57 school districts and public school academies ended the 2014 fiscal year either in deficit or with a deficit projected for the subsequent year. These districts' deficits range from slightly more than $5,000 to more than $169 million in the Detroit Public Schools (Michigan Department of Education, 2014). Helping these districts return to a position of fiscal health from which they can deliver quality education is an immediate concern of incredible importance. Although less pressing, implementing a system that could help prevent other districts from being mired in fiscal crisis is equally significant and the focus of this paper.

While much school accountability research has focused on academics (e.g., Clotfelter & Ladd, 1996; Dee & Jacob, 2011; Deere & Strayer, 2001; Figlio & Getzler, 2002; Grissmer, Flanagan, Kawata, & Williamson, 2000; Haney, 2000; Jacob, 2001; Jacob, 2006; Klein, Hamilton, McCaffrey, & Stecher, 2000; Ladd, 1999; Neal & Schanzenbach, 2010; Rouse, Hannaway, Goldhaber, & Figlio, 2007; Smith & Mickelson, 2000; Toenjes, Dworkin, Lorence, & Hill, 2002), very little has focused on school fiscal accountability. However, school fiscal accountability has become an increasingly contested topic in numerous states across the country. The recent economic recession and a reduction in both federal and state aid to public schools have tightened the public school purse strings (see Leachman & Mai, 2014). As education budgets are squeezed, local schools districts often must implement policies and programs that require more personnel, time, and resources.

In some states, tightened purse strings and new state mandates have been coupled with difficulties maintaining local support for public schools, declining student enrollment, and increasing retirement system obligations. Michigan, for example, has experienced a graying of its population (as seen in **Figure 1**), which,

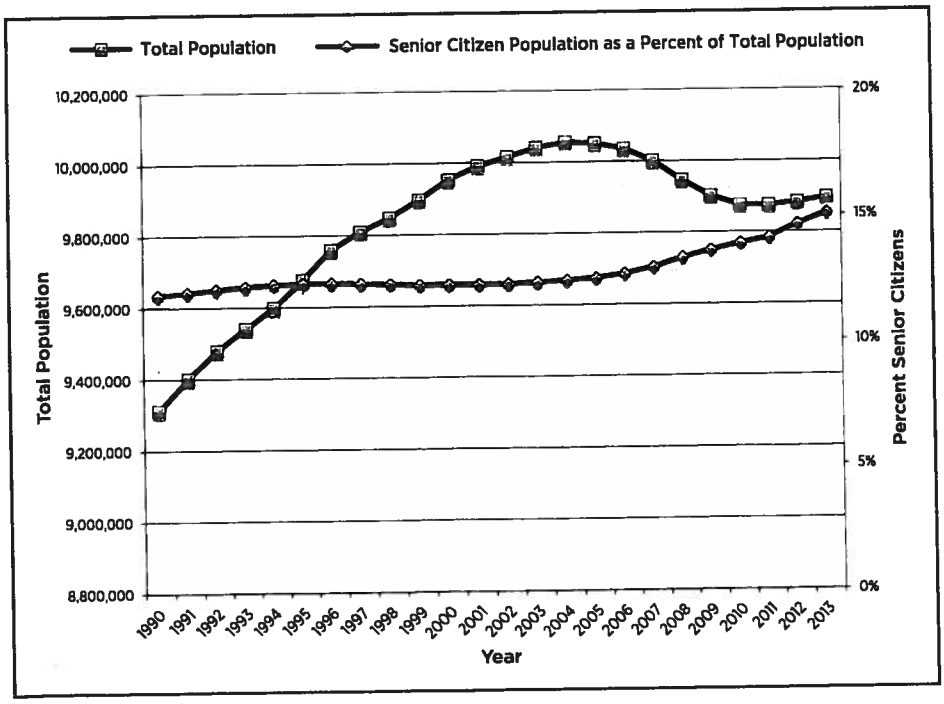


Figure 1. Michigan Total and Senior Citizen Population Trend, 1990–2013

Source: Michigan Department of Community Health

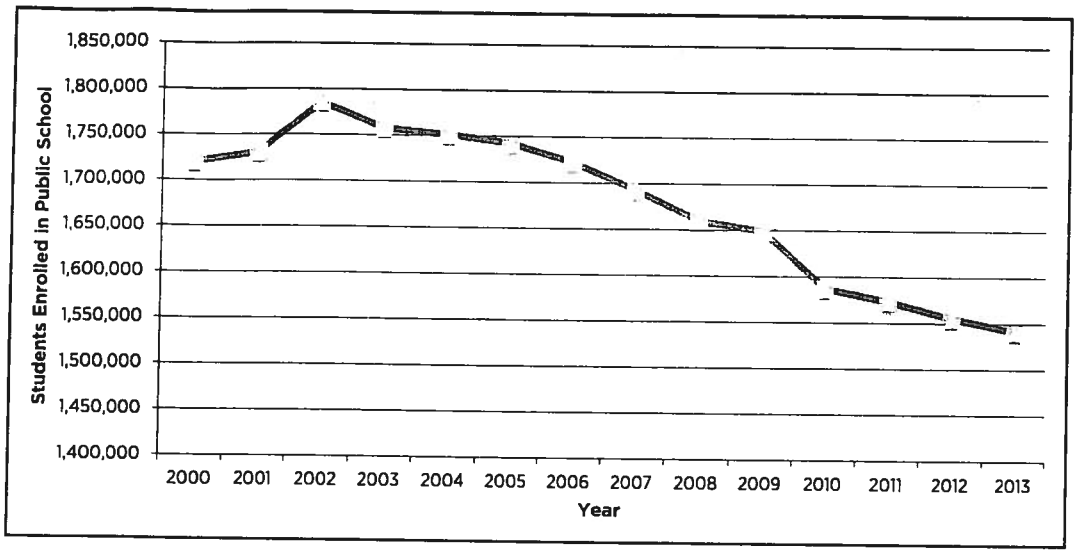


Figure 2. Michigan Public School Enrollment Trends, 2000–2013

Source: U.S. Department of Education, National Center for Education Statistics, Common Core of Data (CCD), "State Nonfiscal Survey of Public Elementary/Secondary Education," 1990-91 through 2011-12

in some cases has meant that fewer voters have been willing to support local public school tax efforts from which they see no direct benefit. As its population has aged, Michigan has also experienced a dramatic decline in traditional public school enrollment (as seen in **Figure 2**). While many school districts have experienced enrollment decline, large urban areas such as Detroit and Flint have experienced massive disenrollment in traditional public schools that has resulted in a dramatic decrease in per-pupil state revenue. Such decreases in per-pupil state revenue rarely coincide with equally dramatic decreases in fixed costs; thus, districts often find it difficult to reduce expenditures at the same rate as the reductions in their revenue.

Yet another issue affecting districts' fiscal health is the increasing state public school employee retirement system contribution obligations. In Michigan, factors such as a declining number of active members of the system (currently, public school academies have the option of participating in the state public school employee retirement system) and increasing health care costs have pushed up the contributions that districts are required to make to the Michigan Public School Employees Retirement System (MPSERS). On average, nearly $1,400 of a district's per-pupil revenue in 2012 never made it to the student but, instead, went directly toward district MPSERS payments (Citizens Research Council, 2013). This amount is nearly double the average district contribution per pupil in 2004. Thus, while state school aid has ostensibly increased over the past four years, many districts have had to allocate the majority of those funds directly to MPSERS. Not surprisingly, the combination of a graying population, enrollment decline, and increasing MPSERS obligations has led to an incredible amount of fiscal stress in many Michigan school districts.

In response to the increasing number of districts experiencing fiscal stress, in 2014, the Michigan legislature proposed an early warning finance system to allow the state government to intervene in districts that are either experiencing financial stress or appear to be headed in that direction. In the next section, the authors describe the evolution of Michigan's state-level response to school districts' fiscal crises. Subsequently, the authors will compare the early warning system currently being discussed in Michigan with such systems in other states as well as research related to indicators of school district fiscal distress. Finally, the authors will provide recommendations for consideration when developing an effective and efficient early warning system for school districts.

The Evolution of Michigan's Response to School Districts' Fiscal Crises

State Intervention in Financially Stressed Local Governments

Prior to 1988, the State of Michigan dealt with local government financial emergencies on an ad hoc basis. Beginning with Public Act (PA) 101 of 1988, the governor gained the authority to appoint emergency financial managers when municipalities were in fiscal crisis. In 1990, the state legislature expanded on PA 101 via PA 72, making the law applicable to school districts. Additionally, PA 72 charged a state-appointed review board with examining any local government that failed to pay debts, failed to pay employee salaries, requested a review, or received a review request by the state treasurer or a state legislator. If the review board found that a financial emergency existed, the Local Emergency Financial Assistance Loan Board was required to appoint an emergency financial manager to the local government. Detroit Public Schools was the only school district placed under an emergency financial manager under PA 72.

In 2011, the Michigan Legislature once again amended the local government financial emergency system via PA 4. This iteration of the law allowed emergency financial managers to essentially become comprehensive emergency managers, empowering them to strip locally elected officials such as school board members of their power and renegotiate, alter, or void union contracts. Additionally, PA 4 expanded the trigger for state review, allowing the Michigan Department of Treasury to conduct a review if "probable financial stress" was found. If a financial emergency was found to exist, PA 4 allowed local officials to propose a plan to correct the situation that, if approved by the state financial review panel, would be endorsed as a consent agreement. However, if the local government did not have a plan or the plan was not approved, the state financial review panel was able to recommend an emergency manager to take control of the local government. Under PA 4, two additional school districts, Muskegon Heights and Highland Park, received an emergency manager.

In 2011, Public Act 4 was repealed by referendum. Thus, PA 72 came back into effect – but not for long. In 2012, the Michigan Legislature enacted The Local Financial Stability and Choice Act of 2012 (PA 436). Since one of the oft-cited reasons for voter repeal of PA 4 was the lack of local discretion over state entry and exit processes and procedures, the new law (PA 436) allowed local officials to choose between four different forms of state intervention: a consent agreement, mediation, an emergency manager, or Chapter 9 bankruptcy. Additionally, unlike PA 4, the new law required the state government, rather than local government, to pay emergency manager salaries and created a transition advisory board to help local governments exit out of state takeover. Another important element of PA 436 was its inclusion of an appropriation, which made it immune to referendum.

PA 436 specified a long list of triggers that would prompt a preliminary state review including, among others, missed payroll, missed pension payments, default in bond payment, breach of a deficit elimination plan, violation of the uniform budgeting and accounting act, failure to file an annual financial report or audit that conforms with the uniform budgeting and accounting act, local petition of five percent of gubernatorial election voters requesting one, local board of chief administrative officer request, creditor's written request, and legislative request. Although two additional school districts are now bound by consent agreements pursuant to PA 436 (Pontiac and Benton Harbor), no additional schools have been placed under an emergency manager under PA 436. However, the previously appointed emergency financial managers under PA 72 and PA 4 in Detroit, Muskegon Heights, and Highland Park effectively became emergency managers with all of the emergency manager powers encompassed in PA 436.

School District Fiscal Distress Transparency

In addition to the aforementioned laws that provide for state intervention in local governments (including school districts) under fiscal stress, the State School Aid Act has, for nearly four decades, required the Michigan Department of Education (MDE) to compile a list of school districts that have incurred a deficit or are projecting a deficit as well as report on the progress made in reducing such deficits. The Michigan state superintendent of public instruction must publicly present the report to the Senate and House K-12 education appropriations subcommittees. Additionally, if a school district is placed on the MDE's list of deficit districts, the district must submit monthly monitoring reports on revenues and expenditures to the MDE. If the district fails to comply with this requirement, the district must then submit a deficit elimination plan (DEP) to the MDE for approval and, upon approval, implement the plan in the district.

Deficit district reports dating back to December 2012 are publicly available on the MDE website (*http://www.michigan.gov/mde/0,4615,7-140-6530_6605-106599--,00.html*). Data from these reports show that between December 2012 and September 2014, the number of deficit districts increased by 20 percent (this includes both traditional public school districts and public school academies; each public school academy is considered to be its own district). Additionally, of the 76 districts that have been in deficit at any point between 2012 and 2014, just 13 have completely eliminated their deficits and have not gone back into deficit as of 2014. Four deficit districts closed or consolidated. Finally, 34 districts that were identified as being in deficit in December 2012 had not eliminated their deficits as of September 2014.

Perhaps in response to the number of deficit districts continuing to increase each year, Michigan Gov. Rick Snyder, as part of his government transparency campaign, has called for the development of "early warning systems" (*http://www.detroitnews.com/story/news/politics/2014/12/12/snyder-seeks-local-school-accountability/20313045/*) to alert local and state officials of the deepening financial problems in local units of government, including schools (Howe, 2014).

Specific to schools, Gov. Snyder's 2015 budget recommendation (*http://www.michigan.gov/documents/budget/Budget_Presentation_2.5.14_446654_7.pdf*) includes $7.3 million for a team from the Michigan Department of Treasury and the Michigan Department of Education to develop an "early warning system" to help struggling districts (Snyder, Calley, & Nixon, 2014). Additionally in 2014, Gov. Snyder showed his support for the creation of strong financial interventions (*http://michigan.gov/documents/reinvent/SOTS-2014-highlights-final-1-16-v2_444939_7.pdf*) such as those proposed in a package of bills (Senate Bills 951, 952, 953, 954, and 957) that aimed to develop and implement an early warning system to identify financially troubled school districts.

The aforementioned package of bills attempted to assist school districts with finance issues before they incur deficits. To do so, the bills proposed a system in which all school districts would have had to submit an annual budgetary assumption report to the Center for Educational Performance and Information (CEPI) that would have then been sent to the district's constituent intermediate school district (ISD) for review. If either the district's constituent ISD or the state treasurer did not concur with a district's budget assumption(s), the state treasurer would have been required to notify the district (with a copy of the notice sent to the superintendent of public instruction and the district's constituent ISD) and the district would have been required to post to its website a notice that the district adopted a budget that "relies upon unreasonable budgetary assumptions " (Substitute for Senate Bill No. 957, 2014). Ostensibly, this element of the proposed early warning system would have relied on citizens to hold local school boards democratically accountable for making fiscally sound decisions.

The proposed early warning system would have also required local school boards to hold themselves financially accountable by requiring districts to request state technical assistance if they determined that a condition of fiscal distress, a deficit, or conditions indicating a potential financial emergency had arisen or would have arisen. However, it was unclear as to what level of fiscal distress a district would need to be at for a local school board to feel the need to request state technical assistance.

The two aforementioned elements of the proposed early warning system – democratic and self-accountability related to sound fiscal decision-making – are indeed "early" given that the processes could take place prior to the district incurring a deficit. The remaining processes outlined in the proposed early warning system, however, only addressed financial woes after a district was already severely distressed. Similar to PA 436, the proposed early warning system included a series of increasing state interventions for districts identified as being in fiscal distress or having the potential to experience fiscal distress. Under the proposed system, however, increased state intervention was not based upon increased fiscal stress but, instead, upon noncompliance with reporting requirements. For example, a district that notified the Department of Treasury of a condition of fiscal distress could have been required to submit periodic financial status reports to the treasury. If the district failed to submit a periodic financial status report, it could have been required to develop and submit for approval an enhanced deficit elimination plan (EDEP) and submit enhanced monthly monitoring reports on revenue, expenditures, cash flow, debt, other liabilities, assets, budget amendments, pupil membership, and other data relating to finances of the district. This logic assumes that a district that does not submit periodic financial status reports is in a financial emergency and it should thus be required to submit an EDEP. Thus, under the proposed system, noncompliance with regulatory procedures, rather than increasing fiscal stress, triggers additional state intervention.

On the last day of the 2014 legislative session, the majority of Democrats and enough Republicans resisted the early warning finance system bill package and, thus, the bills failed to pass through the House. Gov. Snyder, nonetheless, has said he will remain proactive with an early warning system (Tower, 2014)(*http://www.mlive.com/news/saginaw/index.ssf/2014/12/gov_snyder_on_saginaw_countys.html*). Given that the 2014 proposed early warning system could not garner enough legislative support, it may be beneficial to engage in a discussion around similar financial stress indicator systems in other states as well as around research- and evidence-based indicators of school district fiscal distress.

Research-Based Indicators of Financial Stress

A significant amount of literature has attempted to measure and evaluate how local governments respond to fiscal stress caused by underlying fiscal and economic conditions (e.g., Chernick & Reschovsky, 2007; Ladd & Yinger, 1989; Reschovsky, 1993; Sjoquist, 1996; Skidmore & Scorsone, 2011). In addition to this research on local government fiscal stress, an emerging field of research has focused specifically on school district fiscal stress.

Beginning in the 1980s, school district fiscal stress research aimed to identify various measures of school district fiscal health and stress. In numerous studies, researchers found that personnel costs, local receipts, liquidity ratios, purchased services, investment earnings, pupil population, election results, tax effort, school size, pupil makeup (e.g., special-cost students), and staffing ratios were all related to fiscal distress (Berny, 1982; Lee, 1983; Murphy, 1980; Smith, 1986). Research also suggested that a variety of external factors such as a poor economy, an increasing number of state mandates, and service price changes contribute to school district fiscal stress (Hentschke & Yagielski, 1982; Nelson, 1983). While this research has informed the field, it must be noted that the majority of this research took place in Ohio, a state with an incredibly decentralized education finance system. By contrast, Michigan's system of education finance is unusually centralized.

In the late 1990s and early 2000s, research moved beyond simply studying the relationship between fiscal stress and internal and external characteristics of school districts and, instead, proposed to holistically understand school district fiscal conditions. Ammar, Duncombe, Jump and Wright

(2005) contend that short-run financial conditions (i.e., the ability of the district to pay its bills and balance its budget without extraordinary measures), long-run financial conditions (i.e., the capacity of the district to finance adequate services over the long run without onerous tax and debt burdens), economic conditions (i.e., the impact of the local economy on the district's capacity to raise taxes and on the expenditures needed to reach adequate student performance), and student performance are suitable indicators of school district fiscal conditions.

DeLuca (2006), however, suggests that even these holistic models that ostensibly predict fiscal stress cannot be generalized to fit every school district since factors that cause districts to differ may also play an important role establishing benchmarks for predicting fiscal stress. Thus, research would suggest that while there are some indicators of fiscal stress that re-emerge in multiple studies (e.g., liquidity ratios, tax capacity, wealth, student enrollment), the extent to which these indicators can predict fiscal stress may vary widely by state, district, and school.

Evidence from Other States Related to School District Fiscal Stress

The majority of state policy related to district fiscal stress is reactive rather than proactive. For example, in Florida, Ohio, Nevada, New Jersey, California, Arizona, Arkansas, Illinois and West Virginia, school districts are subject to state review and/or oversight only after the district incurs an operating deficit, applies for an emergency loan, or is not able to make payroll, transfer sufficient funds to retirement or benefit systems, pay claims from creditors or pay short- or long-term loans. These systems do not provide districts with an early warning since a district that, for example, has failed to make payroll is clearly already in severe fiscal distress.

States such as New York and Pennsylvania, however, have designed systems that provide districts with financial data on a regular basis and thus allow districts to monitor their financial health and request assistance if the data indicate the district's financial health is declining. For example, the Pennsylvania Department of Education (PDE) is required to regularly analyze the financial condition of school districts and identify districts that may be subject to financial stress and are therefore eligible to receive technical assistance from the department. The PDE uses budget and other financial data that districts submit in their annual financial reports. The PDE considers the following data in each district: fund balance ratio, borrowing base capacity, debt ratio, basic education funding advances, bond intercept payments, market value/personal income aid ratio, equalized mills, and school tax ratio, among others. It also considers whether any political subdivision located within the district has been declared financially distressed by the Pennsylvania Department of Community and Economic Development. If the PDE determines a district may be experiencing financial difficulty, it contacts the district and may ask the district to provide additional, current information about its financial status such as current budget, cash flow analysis, fund balance, and status of audits. Upon retrieval of the data, the PDE works directly with the district to analyze the data and then chooses to either continue to monitor the district or place the district in financial watch status. If placed in financial watch status, the PDE provides technical assistance to the district. This technical assistance involves PDE employees and consultants provided by the PDE: a) working with district staff to evaluate programs, practices, and procedures, b) identifying best practices, c) sharing potentially useful information, and d) serving as liaisons for the district with the PDE in ways that are aimed at helping the district return to fiscal health (Pennsylvania Department of Education, 2013).

Similar to Pennsylvania, New York has implemented a fiscal monitoring system drawn from data that schools already submit to the Office of the State Comptroller. New York's fiscal health monitoring system evaluates schools based on both financial and environmental factors and provides two separate indicator scores.

The financial indicator is calculated using data from school district annual financial reports and is made up of weighted sub-indicators (e.g., unassigned fund balance, total fund balance, operating deficits, cash ratio, cash percent of monthly expenditures, short-term debt issuance, and short-term debt issuance trend). Similarly, the environmental indicator is calculated using data from the U.S. Census Bureau, New York State departments of Labor, Taxation and Finance, and Education and is made up of weighted sub-indicators (i.e., change in property value, change in enrollment, budget votes, graduation rate, and free and reduced-priced lunch status). New York chose to include environmental indicators, rather than focus solely on fiscal indicators, because factors outside of the immediate control of local officials (e.g., population loss, property value stagnation) make it difficult to avoid fiscal stress (OCR, 2013, 2014).

Once the state comptroller calculates each indicator, each district receives a financial and environmental score. Districts that compile 65 to 100 percent of the financial available indicator points are labeled as being in "significant fiscal stress," 45 to 64.9 percent as "susceptible to fiscal stress," and 25 to 44.9 percent as "no designation." Districts that compile 60 to 100 percent of available environmental indicator points receive a designation of "###," 45 to 59.9 percent of "##," and 25 to 44.9 percent of "#."

In the New York system, the state comptroller does not have the authority to intervene in school districts regardless of the fiscal stress indicators. The system relies on democratic and self-accountability so that citizens who see the district's indicators can hold their elected officials accountable and elected officials can hold themselves accountable by seeking support from the state. The state offers districts with fiscal stress a multitude of support in the form of budget reviews, technical assistance, multi-year financial planning, local government management guides, five-year financial comparisons, and a full menu of training offered by the Office of the State Comptroller.

Recommendations

A thoughtful system that provides school districts and the public with transparent indicators of district fiscal health has the potential to reverse the current trend of an increasing number of deficit districts in Michigan. Such a system, however, should focus on collaboration between the state and a district rather than compliance-based sanctions. The focus of the system should be to provide districts with measures of fiscal health, rather than only warnings of fiscal stress. In a fiscal health indicator system, it may also be desirable to provide continuously healthy districts or districts who continuously improve their fiscal health with rewards as opposed to the recently proposed system that only distributes sanctions to those deemed to be fiscally stressed.

A fiscal health indicator system should not base increasing state intervention solely upon noncompliance with paperwork requirements or indicators of fiscal distress that reveal only acute financial strain. Such a system should provide districts with technical assistance, support and training, and should increase state intervention when district fiscal health declines. Additionally, given that districts headed toward or in fiscal distress are already financially strained, a thoughtful system should not withhold funding from fiscally distressed districts or ask districts to expend additional resources on data collection and transmission. A significant amount of publically available data exists that, when aggregated and analyzed, can provide the state government and districts with great insight into district fiscal health.

When it comes to holding schools accountable for making fiscally sound decisions, a system that provides both districts and the public with transparent, useful, easy-to-understand data is ideal. While many states such as New York, Pennsylvania, Illinois and New Jersey – as well as Michigan – have easily available public school finance data, much of this data is presented in such a way that it is not accessible to the public. The state should utilize publically available data shown by research to be suitable indicators of fiscal health to develop a simple, yet robust, financial health indicator system (see **Figure 3** for a sample system). However, any type of indicator system aimed to inform the public should be developed with great caution. While financial data is ostensibly more objective than assessment data, research does indicate that states should take caution in developing academic accountability systems that aggregate assessment data to provide districts with a single indicator of academic success. Research by Jacobsen, Saultz and Snyder (2013) (*http://epx.sagepub.com/content/27/2/360.abstract*) contends that sometimes efforts to make academic accountability data transparent and clear backfire (*http://msutoday.msu.edu/news/2013/how-school-report-cards-can-backfire/*). They suggest that when a school is assigned declining grades over time, this may result in decreased parent satisfaction, declining enrollment, declining donations and volunteers, and even a drop in housing values. This research should certainly be considered in the development of any sort of financial health indicator system.

Finally, a fiscal health indicator system must take into account local context and leave room for local and state discretion in determining fiscal health and publically explaining fiscal decisions. For example, districts of different size and geographic locations, and districts serving various student populations must consider different priorities and needs when making financial decisions. It may be desirable to create a state-appointed board to oversee the financial health indicator system, review district financial health indicators and district contexts, and reach out to districts to provide support and assistance to those whose data seem to indicate they may be susceptible to fiscal stress. The financial health indicator system board should be non-partisan with board members appointed by the governor, state superintendent, the State Board of Education, the state treasurer, minority and majority education committee leaders in the House and Senate, and other individuals who can be held democratically accountable for making thoughtful decisions to appoint individuals with background experience and expertise in public school finance, financial management or both, and who will implement a fair, transparent, efficient, and effective financial health indicator system.

Figure 3: Sample Financial Health Indicator System Transparency Tool

2014-15 Financial Health of Pine City School District

A judgment about the financial health of a school district must take into consideration its unique circumstance, but can generally be defined as a school district's ability to generate/obtain enough revenue to meet its expenditures within current or immediate future fiscal periods. Any attempt to identify financial health must recognize that changes in behavior, the specific financial decisions made by the school board, or unforeseen external events, can quickly change ongoing financial trends. These local actions can impact the financial health of a school district suddenly, either for better or worse. The State of Michigan is committed to supporting districts in the financial management of their schools and will ensure all districts are able to obtain the necessary assistance and resources to make informed, healthy financial decisions to ensure all students have an equitable and adequate education experience.

Current Financial Health Indicator

★★★☆☆

15 out of a possible 25

The current financial health indicator measures the fiscal health of your school district with current-year fiscal health indicators. The better fiscal position the district is in, the more stars awarded to the district's indicator.

Sub-Indicator	Measure	Points for this Indicator
Liabilities-to-assets ratio	.091	2
Other indicator 1		
Other indicator 2		

Financial Trend Indicator

★★★☆☆

23 out of a possible 25

The financial trend indicator measures the fiscal health of your school district over time using three to five years of fiscal health data. This rewards districts for improving fiscal health over time.

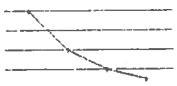
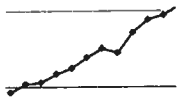
Sub-Indicator	Measure	Points for this Indicator
1-year % change in liabilities-to-assets ratio	.01	5
2-year % change in liabilities-to-assets ratio	.023	4
Other indicator 2		
Other indicator 3		
Other indicator 4		

Environmental Indicator

★★☆☆☆

8 out of a possible 20

Research shows that districts with certain characteristics (e.g., consistently declining enrollment, increasing MPSERS obligations, and charter school competition are more likely to experience fiscal districts. The environmental indicator measures the districts' current environmental characteristics. The more environmental characteristics a district has that are associated with districts that tend to go into fiscal distress, the fewer stars awarded to the district's indicator.

Sub-Indicator	Measure	Points for this Indicator
Enrollment Trend		2
MPSERS Obligation Trend		2
Trend in Resident Students Enrolled in Another District		3

Current Number of Resident Students Enrolled In Another District: **153**

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