Who Should Be in Charge When School Districts Go into the Red?

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Foreword

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One of the most hotly debated issues in American education today revolves around low-performing schools and districts: how to define "low-performing," what to do about them, and who gets to decide. That's at the heart of the deliberations—and arguments—over the No Child Left Behind reauthorization now moving through Congress.

But there's another species of "failing" schools and districts that doesn't attract the same controversy, even though it should: institutions that are financially insolvent, or headed there.

Virtually everybody agrees that states must act to address financial distress in public schools and districts to protect students, taxpayers, and the states' own credit ratings. But how are they to determine what to do in these difficult situations? The relative lack of fuss and furor doesn't mean it's easy to decide, much less take effective action.

This policy brief offers some suggestions based on the hard-earned experience of leaders nationwide.

It addresses questions such as who should be in control when districts are on the verge of not being able to pay their bills, what supports and sanctions should be put into place, and under what circumstances districts should be subject to state takeovers.

These pages explain the interim steps that may succeed in righting a district's fiscal ship. For instance: The state (or county) should appoint a budget officer for the district who will assess enrollment, revenues, and expenditures and determine what next steps may enable the district to sail a straighter financial course. The recommendations are not rocket science, but straightforward common sense—which, as this brief attests, is all too seldom practiced within dysfunctional organizations.

It's that dysfunction that lies at the root of the problem. Districts go insolvent because there are insufficient counter-pressures on their leaders to *stay* fiscally solvent. Existing leaders and wannabes are often rewarded—through elections, appointments, or re-appointments—when they make promises that obligate monies down the road. Employees of the system often push for higher salaries, expanded benefits, retirement sweeteners, and other advantages that the district simply can't afford—but that union-friendly boards agree to anyway. Such long-term obligations are largely what put districts in the hole (though that fall may not be palpable until someone else is in command).

Yet leadership is not the sole culprit. Communities rarely embrace tough trade-offs and would rather play kick the can with education officials. Our suggestions, then, should be seen in part as ways to lean on school boards and superintendents to take their fiduciary responsibilities seriously, and to counteract the pressures of unhelpful local politics.

Let us be clear: This brief is for those districts that have a decent chance of turning themselves around for the benefit of their pupils, citizens, and taxpayers. It's not for places that are already too far gone. Some districts aren't worth saving. They are too bankrupt, financially and/

or academically, to invest in any further. For them, the time for more supports and more cash has passed. They need *real* governance change in the form of state takeover, outsourcing of their schools (perhaps to a "recovery" district), and maybe even closing the district.

Yes, that's blasphemy in most education circles. But it is entirely possible that state policies could be thoughtfully designed that would shut down a district's central office and transfer leadership, operations, and funding in ways that could lessen the sting. It would be traumatic in the short run for families, students and staff. And no, it doesn't make sense everywhere. Closing an existing district would require the right conditions, including having new providers and top-flight teachers at the ready. It would take courageous state and local leaders with a break-the-mold mentality. In the long run, however, it could be better for kids in the same way that the educational aftermath of Katrina was largely positive for the children of New Orleans.

Better, though, would be to not allow districts to get in this mess in the first place! As one of us has observed, the best state policies would prevent districts both from "deficit spending" (which occurs due to pensions and retirement health care) and from obligating out-year expenditures—such as when they sign a five-year labor contract although there's ample uncertainty as to what revenues will look like in five years. This is madness.

Hank Williams, Jr. sings a well-known ditty, "Family Tradition," in which he blames his own bad behavior on his wayward ancestors.

But that's akin to saying that we spend money we don't have because that's how it's always been done. This is surely no way to run American schools—even if it makes a fitting final song at a wedding reception.

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Executive Summary

School districts across the land are contending with rising education costs and constrained revenues. Ballooning retirement obligations and ever-growing personnel expenditures in particular are leaving many district budgets in the red.

Yet state policies for assisting school districts in financial trouble are uneven and complex. Interventions are often haphazard, occur arbitrarily, and routinely place politics over sound economics.

This brief presents a menu of sensible state responses when districts are insolvent or nearly so, as well as a tiered sequence of interventions that range from help to actual takeovers (see below).

Potential remedies take the form of *new people* (individuals or groups who govern the district in addition to, or as replacements for, the existing board and administration), *new powers* (additional or expanded measures that the district is now permitted to take), and *new money* (financial support in the form of grants or loans). The suggested system combines those three levers in several ways, noting that timing matters as much as the interventions themselves and failure at one step triggers the next.

Few districts need drastic measures. Quiet technical assistance is often enough to help local leaders project revenue accurately and adjust expenditures to match. External advisors can also give district leaders political cover to make unpopular decisions. The fear of greater consequences is motivating too, which is welcome news since most states aren't equipped to run districts. Financial disasters can be averted in the majority of districts via strategic interventions that scale up in severity. For districts on a catastrophic course, however, "takeover" is warranted—and from the perspective of students and taxpayers, it is even essential.

Tiered interventions for districts in financial distress

1. Collaborative supports

District leaders receive low-impact assistance in managing their finances. Supports might include convening a budget review committee to identify unnecessary expenditures or assisting district finance officers to develop more accurate projections of future revenue. The goal is to work with leaders to recognize and rectify the causes of distress.

2. Financial management

At this stage, experts are no longer advisory; they now oversee and manage a district's financial matters. The goal is immediately to improve district finances so as to avert costly bailouts down the line, while building the capacity of district leaders to manage once the experts leave.

3. Administrative control

Otherwise known as a state takeover. Outside experts manage the entire district, not just its finances. A state-appointed administrator and/or governing commission replaces or supersedes the superintendent and board and operates with additional powers. Changes in district management can be accompanied by an emergency loan if necessary, although any major financial assistance should hinge on complete administrative control. The goal here is to remove ineffective leaders and prevent district bankruptcy and closure.

Introduction

Back-to-school time inspires visions of new clothes and backpacks, unsharpened pencils, and clean notebooks. But frequently in Philadelphia, it has been accompanied by threats of mass layoffs, increased class sizes, slashed support services, and doubts as to whether schools will open at all. The School District of Philadelphia's (SDP) ongoing fiscal troubles are due to a combination of decreased revenue, rising costs, and declining enrollment, a story that is all too familiar. In 1998, former Superintendent David Hornbeck threatened to shut down the struggling district and filed lawsuits to force the state to provide additional funding. The state's education secretary responded in 2001 by signing a "Declaration of Distress," and the state legislature approved emergency funding contingent on replacing the local school board with a School Reform Commission. One of the nation's largest school districts was being externally managed by a five-member commission: three people appointed by the governor and two by the mayor.

In the fifteen years that followed, the commission adopted numerous strategic plans, implemented a portfolio model for school management, and attempted to terminate the district's contract with the Philadelphia Federation of Teachers. Emergency funding continued as well: The latest infusion from the state was a $104 million aid package from Governor Tom Corbett in 2013. However, Philadelphia still remains in incomprehensible financial trouble. As of the 2014–15 school year, the district had massive deficits—to the tune of $320 million.[1] In March 2015, Governor Tom Wolf replaced the head of the School Reform Commission, noting, "The School District of Philadelphia is in dire financial straits, and our children are being put at a disadvantage as a result of misguided cuts and poor decisions."[2] The incoming chair is the commission's sixth.

Philadelphia is hardly alone. In Michigan, nearly 7 percent of all traditional school districts and charter school districts (57 of 843) were operating at a deficit at the end of the 2013–14 fiscal year.[3] Over 25 percent of New Mexico districts (23 of 89) required emergency state aid in 2013–14.[4] The Cleveland Municipal School District, home to over forty thousand students, anticipates a deficit of over $184 million by 2017.[5,6] Chicago faced a mind-boggling $1 billion deficit in fiscal year 2014.[7] In 2014, Detroit closed twenty-six schools, eliminated more than five hundred jobs, and still ended the year with a $120 million deficit (which has since grown by an additional $50 million).[8] And financial issues were so severe in two Kansas school districts that they ended the 2014–15 school year early to save money.[9]

But the news isn't entirely bleak everywhere that districts run into financial trouble. Take, for instance, California. In 1991, the Richmond Unified School District filed for federal bankruptcy, and at the time, the state had virtually no mechanisms to address sufficiently the district's problems. After the district went under, lawmakers enacted a system of monitoring, supports, and interventions for nearly insolvent districts, with state takeover as a last resort. In the past fifteen years, hundreds of districts have recovered from financial jeopardy.[10]

> A lot of [the problems] are, quite frankly, bad decisions. There are thirteen thousand school districts. Somebody, right now, is making a horrific decision that maybe two to three years from now will put their school district at financial risk.
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> **— Education finance analyst and consultant**

The aim of this paper is to propose governance policies that restore solvency once districts are identified as being in trouble. (We focus specifically on financial failure, not academic failure, though the two often go hand in hand.) It is not for those districts that have already sunk, but rather for those that have just begun to take on water. We argue that the policies and processes for districts in financial distress should exist in a continuum, starting with prevention and moving through assistance, intervention, and direct management. Throughout, we include examples from states that have successfully implemented interventions and describe the fate of those that didn't.

Too big to close?

Though many districts struggle to remain on solid financial footing, a handful of large, chronically troubled ones dominate the headlines (such as Philadelphia, Detroit, and Camden). Due to their size, the consequences of insolvency for students, the city, and the regional economy would be particularly disastrous. As a result, state legislatures often carve out unique governance arrangements, invest greater resources, and stay involved for longer periods of time than they would otherwise. Though this brief is not about these headliners, we summarize their troubled history and subsequent interventions below.

Philadelphia

After the School District of Philadelphia perpetually ran deficits in the 1990s, the state enacted in 2001 a law allowing it to replace the local board with a School Reform Commission (SRC) in "first-class" districts (those serving cities with at least one million residents, which in practice meant just Philadelphia). With members appointed by the governor and mayor, the SRC has broad powers over district finances, including the ability to dismiss and appoint leadership, approve budgets, and renegotiate contracts.[11] (Notably, the SRC cannot levy taxes, and as of 2015 the state courts have prevented it from cancelling the collective-bargaining agreement with the teachers' union and imposing a new one.)[12,13] In 2001, SDP had a deficit of nearly $217 million, and the seating of the SRC represented the largest state takeover in history.[14] Yet SDP's budget hole persisted. In the past fifteen years, the district has regularly run deficits in the hundreds of millions, and it has more than once relied on stopgap loans or one-time infusions of revenue.[15] At the same time, it has experienced high leadership turnover—six SRC chairs and seven superintendents since the takeover.[16] As of summer 2015, the district projected an $85 million deficit and requested an additional $264 million from the city and state (on top of its base revenue) to execute its 2015–16 academic plan.[17]

Detroit

The problems in Detroit Public Schools have been decades in the making. A declining population, economic pressures, and dismal academics led the state to allow the Motor City's mayor to remove and replace the school board in 1999. Unfortunately, the move failed to improve the district's academics—and corruption and mismanagement turned a $100 million dollar surplus into a $200 million deficit.[18] In 2005, the district regained its elected board, only to have the state step in again in 2009 and appoint an emergency financial manager in the face of a $408 million dollar budget hole.[19] Along the way, the emergency managers have been granted broader legal powers, and they now have the authority to restructure contracts and supersede elected officials.[20] However, six years and four emergency managers later, the district posted a $170 million deficit for fiscal year 2014 (and projects a $320 million deficit in two years), with no relief in sight. Its two largest problems are pension obligations and declining enrollment.[21] The district owes the state $53 million in pension payments and is accruing what amounts to approximately $10,000 per day in late fees and interest.[22] And in fall 2014, student enrollment dipped to under fifty thousand from three times that number only a decade ago.[23] In the past, the district relied on stopgap funding and cash advances to meet payroll and to pay short-term operating expenses.[24] Governor Snyder's current long-term plan includes dividing the district in half, with the "old" district paying off debt while the "new" district operates the schools.[25]

Camden

Although Camden is just across the state line from Philadelphia, a much different climate guides legislative action in New Jersey. The state was the first to enact a takeover law, and between 1987 and 1995 three districts fell under state control (Jersey City, Paterson, and Newark).[26] Camden's problems became front-page news when it posted a $14 million deficit in 2001. The next year, a fiscal intervention team reported that the budget and monitoring process was "chaotic, dysfunctional, and almost completely ineffective" and found the district "disinterested in efforts to cooperate on improvement efforts."[27] Subsequent interventions had only moderate results. A fiscal monitor, who functioned in an advisory capacity, was installed permanently in 2006, yet the district retained fiscal decision-making authority and the deficit ballooned from $10 million in 2006 to $75 million in 2014.[28] In 2013, the state finally took over and hired a superintendent to work with a school board appointed by the mayor; the next year, the district laid off more than three hundred employees (including two hundred teachers).[29,30] The district projects that it will lose 2,730 students (and more jobs) in 2015–16.[31]

Districts like these are too big to close, yet they are too far gone to save through conventional interventions (as explained herein). As such, not only should administrative control occur *sooner*, but it should be *more severe*—perhaps replacing both the board and superintendent and providing them with additional expanded powers.

> Insolvencies are rare. They're not occurring in most places. But when they occur, you have to be ready for it. It's the financial equivalent of a natural disaster....Some of it you can predict and prepare for, but when they happen you have to have a process in place.
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> **—School finance consultant**

Three fundamental premises underlie this paper. First, it makes no sense for states to assist districts in distress by simply pumping more money into them without changes to leadership and/or governance arrangements. Second, most districts in distress (or potential distress) can and should be righted through fairly straightforward interventions. In other words, major disruptive actions, such as replacing the district superintendent and school board, can be avoided if districts get their act together the first time. Third, the size and clout of a handful of districts—Philadelphia, Detroit, Chicago, Cleveland, and Camden come to mind—render them "too big to fail," yet their colossal problems justify major disruptive actions, as those are precisely what may best serve students (see *Too big to close?*).

What *could* happen when districts go broke?

Interventions for districts in financial trouble are diverse, complex, and vary in severity. To organize them, we define three types of remedies: *new people*, or individuals who govern the district in addition to, or as replacements for, the existing school board and administration; *new powers*, or additional or expanded measures that the district is allowed (or sometimes forced) to take; and *new money*, or additional financial support. Below, we describe various options for each. In the section that follows, we present the options that appear to be most effective and the sequence in which they should occur.

New people

Financial advising. The state and/or municipality appoints a recovery officer, reform commission, or other individual or group that oversees, advises, and assists (but does not supersede or replace) the district's school board, superintendent, and/or chief financial officer.

Financial management. The state appoints a financial manager, oversight panel, or other individual or group that has complete authority over district finances. Managers supersede or replace the school board, superintendent, and/or district chief financial officer when it comes to financial matters but not when it comes to other issues.

District management. The state appoints an individual or group with authority over all district decisions (financial, operational, academic, and so forth). Forms of district management include receivership and emergency management. Depending on the state, district managers may themselves have advisory boards. Complete district management is commonly referred to as "takeover."

New powers

Asset liquidation. District leaders may sell district assets, including property and unused buildings.

Taxes and bonds. District leaders may levy taxes in order to repay debts. (Usually, school boards levy property taxes, contingent upon voter approval. In some cases, other governing bodies, such as city councils or county boards, must levy taxes on behalf of the district.) They might also repurpose existing taxes for debt repayment. Finally, they might sell bonds (again, with voter approval), meaning that they borrow money from the taxpayers with the promise that the bond will accrue interest over time and become more valuable to the purchaser.

Contract alteration. District leaders may be able to renegotiate or dissolve any contracts made by the insolvent district. Depending on the state and district, this could apply to vender/supplier contracts, employee contracts, or both. (Employee salaries, benefits, and retirement obligations are codified by collective-bargaining agreements and also comprise districts' largest expenditures. Thus altering contracts is one way to address these costs.)

Dissolution/consolidation. District leaders close the school district, merge it with a neighboring district, or turn schools over to charter operators.

Chapter 9 bankruptcy. Some states allow municipalities, including school districts, to file for Chapter 9 bankruptcy. Although extremely rare and a very last resort, when a district declares bankruptcy, a federal bankruptcy judge can permit it to raise funds to meet existing financial obligations and renegotiate the terms of debt repayment with creditors (for example, San Jose went this route in the early 1980s). (See *Bankruptcy blues* for more.)

New money

Small-scale advances. The state provides the district small, short-term advances against future revenue. These advances represent only a small percentage of a district's operating costs.

Large grants or loans. The state offers the district a long-term loan, grant, emergency bailout, or other financial intervention that comprises a large fraction of the district's total operating budget. Depending on the amount and terms of the revenue infusion, a district may or may not be responsible for repaying these funds.

Note that often these policies are combined with or made contingent upon one another. In many states, for example, in order to receive a large loan from the state, a district must usually agree to new people (such as a financial manager) as well. Sometimes, new or expanded powers are only available once governance changes have been implemented—for example, a state-appointed financial manager might have the authority to alter contracts or dissolve a district (whereas the prior superintendent could not). The most extreme options, such as complete takeover by the state, a massive bailout, or dissolution of the district, are often available only after gentler actions have been tried and have failed or if it becomes apparent that part of the problem is extreme mismanagement (such as fraud).

What should happen when districts go broke?

In the prior section, we presented a menu of the range of possible interventions with varying degrees of severity.

Bankruptcy blues

Bankruptcy holds a prominent place in the rhetoric around finance, usually as a symbol of spectacular financial corruption, gross mismanagement, and abject failure. However, it's an option more commonly associated with corporations or individuals rather than the public sector. The primary reason is that only twenty-nine states allow public municipalities, including school districts, to declare federal bankruptcy ("Chapter 9" of the bankruptcy code). Even in those states, Chapter 9 is an option of last resort: It is viewed (justifiably) as a stigma that destroys public trust, curbs economic growth, and negatively affects a municipality's credit and that of surrounding cities and towns. Chapter 9 is also undesirable because it is unpredictable; decisions are completely out of either state or local control and are made instead by a federal judge only concerned with finances. Officials in a bankrupt city or district are unlikely to be reelected. School districts are even less likely than cities to declare bankruptcy because, given their mission, they are typically subject to vigilant financial oversight. In addition, states usually intervene before a district's finances reach catastrophic levels, even if the intervention is an emergency bailout so the district can make payroll, because the ultimate responsibility for providing and delivering education lies with the state.

Should a municipality file for Chapter 9, it negotiates a plan with its creditors to resolve outstanding debt, which typically entails dissolving and rewriting contracts and collective bargaining agreements, reworking obligations to retirees, or levying taxes (sometimes even if those actions are not otherwise permissible under state law). The intent is reorganization, not liquidation or closure, so that municipalities can continue operating while they eliminate their debts. In fact, a bankruptcy court cannot compel the municipality or district to sell any assets for this reason.

Although it is rare for municipalities to declare bankruptcy, it has happened. Of the 312 municipal entities that have filed for Chapter 9 since 1954, six were school districts:

- 1983: San Jose School District, California
- 1986: Cooper River School District, Alaska
- 1986: Lassen Community College District, California
- 1991: Richmond Unified School District, California
- 1992: Ellicott School Building Authority, Colorado
- 1992: Chilhowee R-IV School District, Missouri

In this section, we outline a three-stage process for assisting fiscally troubled districts that draws from the menu. Although a state might not need to implement all the steps at each stage, it is critical that a state has three stages and that it implements interventions in a sensible order. Failure at one stage triggers the subsequent, more severe action. Though aspects of this plan seem both obvious and logical, interviewees tell us that, in reality, interventions are often poorly designed and are rarely implemented successfully.

Recommendations are based on interviews with stakeholders in a variety of states and districts. In each state, we interviewed five to ten experts, some at the state level and some from districts in various degrees of distress (currently insolvent, near insolvency, or post-insolvency). We focused primarily on California, Illinois, and Michigan because of their diverse range of policies. In total, we conducted twenty formal interviews, supplemented by a number of informal conversations and consultations. State-level respondents included chief state school officers, chief state financial and business officers, school board members, financial auditors, representatives of intermediate agencies tasked with monitoring and intervening in district finances, and external financial consultants and advisors. We also reviewed the education code and other relevant state policies. At the district level, we spoke to superintendents, district financial officers, current and former emergency managers, financial advisory board members, and others. Finally, we spoke to several national education finance policy experts to get a better sense of the district insolvency landscape across the country.

Briefly, the three stages are as follows:

1. *Collaborative supports*. Once a district is identified as in distress, the first step is low-impact interventions: small expansions of existing powers, governance changes that assist (rather than replace) existing leaders, and little or no financial assistance. The goal is to build capacity while identifying and rectifying the causes of financial distress.

2. *Financial management*. If collaborative supports prove inadequate or if the cause of distress is gross mismanagement (rather than poor decision making based on incomplete information), districts should then be subject to financial management. This involves new people: experts with the power to oversee and act on financial matters (such as a fiscal manager who designs a district recovery plan and has stay-and-rescind power over board actions but who does not replace the board). The governance change is coupled with a large expansion of the powers of these experts.[32] The goal is to avert major crises further down the line by shoring up the district's finances in the short term and developing local capacity for the future.

3. *Administrative control*. If a district cannot operate without an immediate infusion of additional revenue and the current board and superintendent prove unable or unwilling to follow the direction of a financial manager, the district should undergo a complete governance change. A new state-appointed emergency manager, trustee, or governing commission supersedes or replaces the board and is given greatly expanded powers. Administrative control is accompanied by an emergency loan, if necessary. (Administrative control does not automatically mean major financial assistance—in fact, it may actually render such assistance unnecessary. However, administrative control is always a precondition to major financial aid.)

The remainder of this paper describes precisely what each of these stages entails. (See *An ounce of prevention* for how to avoid the process altogether.) For each, we illustrate how the drivers of new people, new powers, and new money can be leveraged; we include examples of success, or sometimes failure, throughout. We conclude with general recommendations.

1. Collaborative supports: How should states first intervene?

Once a district is identified as in distress—whether that's operating with a deficit, projecting a budget to dip into the red, or using stopgap borrowing—the first step is to assist the district in solving its own problems. This is the collaborative support stage. The goal is to build capacity while identifying and swiftly rectifying the causes of financial distress.

An ounce of prevention

Every interviewee stressed that the best defense against insolvency is preventive medicine. Although proactive policies are not the focus of this brief, here we briefly present recommendations on a monitoring system; the full details of such a system can be found in Appendix A.

State policies for monitoring and prevention:

- Prohibit deficit spending and do not let districts carry a deficit from one year to the next.
- Require that budgets include three- to five-year projections.
- Conduct multiple audits of district budgets and projections by a third party (county, regional, or state office) during the fiscal year. Audits should be conducted using a uniform instrument.
- Review investments to identify risks and potential large future losses.
- Limit the duration of operational contracts and establish triggers for automatic review of existing contracts.
- Mandate a reasonable reserve requirement.
- Discourage short-term, private "stopgap" loans, especially more than one.
- Provide accurate and timely enrollment data.
- Promote district budget stability through a predictable calendar of state budget approval and revenue delivery.
- Reconsider funding mechanisms so districts can react to change.
- Provide districts with access to experts, and don't penalize them for asking for help.

Collaborative supports could take the following form:

NEW PEOPLE

Additional staff can bring fresh perspectives, offer impartial analyses and advising, and provide political cover so that existing leaders can make unpopular but necessary decisions (especially those that involve cutting staff). All new people should be financial advisors, rather than managers with direct authority. Options include the following:

- County or state appoints a budget review advisor or committee to assess enrollment, revenues, and expenditures and, along with local officials, determine what actions to take to regain financial stability. The advisor or committee also makes explicit that not completing these actions could trigger stronger interventions.
- County or state requires district to enlist an external professional financial consultant (rather than assigning one to it).

NEW POWERS

Additional powers are granted in low doses to state and county officials and in even lower doses to existing district leaders. Examples of new powers include the following:

- County or state can require district to submit interim or additional financial reports.
- County or state can require district to create a financial recovery plan, often with the assistance of external consultants (but cannot, at this stage, require the district board and superintendent to implement it).
- County or state officials can cancel purchase orders and other non-salary expenditures based on their review of district finances and/or on the recommendation of the financial advisor.

NEW MONEY

Only as a last resort, district officials can seek small loans from the private sector with the approval of county or state officials.

California has a solid track record in using collaborative supports, as a result of policies originally instituted in response to the bankruptcy of Richmond Unified School District in 1991 (see Figure 1 and Appendix B for more). In short, districts must adopt a balanced budget for the next three years by July 1 and submit it (and, later, two midyear interim financial reports) to the county office of education. The county reviews it and evaluates whether the district is in danger of not meeting future obligations. (California districts are not

Figure 1: California's tiered intervention system

PROACTIVE MONITORING	COLLABORATIVE SUPPORTS	FINANCIAL MANAGEMENT	ADMINISTRATIVE CONTROL
Goal: Keep districts solvent now and in the future by identifying problems and risks	**Goal:** Develop and execute recovery plan with existing district leaders	**Goal:** Oversee financial decision making if local leaders prove unwilling or unable to follow their recovery plan	**Goal:** Avoid bankruptcy and remove ineffective leaders
▪ Districts submit financial reports three times per year to county office of education (current and two-year projections) ▪ Budgets must be balanced for current and future years ▪ County office reviews budget using uniform criteria determined by the state; support phase is automatically triggered for districts in trouble	▪ **NEW PEOPLE**: County assumes a greater role and can bring in a budget review committee, professional financial advisor, and/or state Fiscal Crisis and Management Team (FCMAT) ▪ **NEW POWERS**: None for district leaders; external advisors may prohibit non-salary expenditures, cancel purchase orders, and/or approve short-term loans ▪ **NEW MONEY**: None	▪ **NEW PEOPLE**: County or county designee assumes financial management of district ▪ **NEW POWERS**: County superintendent and/or designee has stay-and-rescind power over the school board ▪ **NEW MONEY**: Tax and Revenue Anticipation Notes (TRANs loans) are issued against future revenue	▪ **NEW PEOPLE**: State-appointed administrator assumes leadership of the district ▪ **NEW POWERS**: Administrator has full authority over all decisions; superintendent is fired and board operates in an advisory role only ▪ **NEW MONEY**: Long-term emergency loan from state general fund is made available

allowed to operate at a deficit.) If the county cannot certify that the district is likely to meet its commitments, it first implements low-impact interventions, including assigning a budget review committee or calling in experts such as other chief financial officers or representatives from the state Fiscal Crisis and Management Assistance Team (FCMAT). Nongovernmental entities like the Council of Great City Schools and the District Management Council may also provide resources to districts. All experts work in an advisory capacity. The school board is not obligated to follow their recommendations, and both the board and superintendent maintain their authority and fiduciary responsibility.

At this point, the district does not receive any additional revenue. It remains completely responsible for implementing the advisors' advice, which usually involves fairly traditional measures such as reducing staff, eliminating or consolidating programs, reducing central-office expenditures, and limiting transportation options.

> You want to continue to build capacity in both the governance structure and the operational structure of the district. Smart county offices always err on the side of collaboration for as long as they possibly can, because that's how you really fix the problem. Trying to be the "budget cop" at too early a level doesn't work.
>
> **—Staff member, California Fiscal Crisis and Management Assistance Team**

California's strategy is predicated on the assumption that district leaders don't automatically become fiscal experts or penny pinchers as a result of financial hardship. Rather, they need additional professional capacity, better data,

Intermediate agencies to the rescue?

Many stakeholders suggested that an intermediate agency, between the state and the district, is best situated to monitor district finances and provide supports within state guidelines. As one interviewee bluntly remarked, "The state's not good at running school districts." Unlike the state, intermediaries can be hands-on and nimble, and they can hire financial specialists rather than education generalists. Without an intermediate agency, lawmakers may be reluctant to even have a support phase because there is no one to manage it. This middleman might be a county or regional agency, a statewide governmental agency, or a private firm. In California, it is a quasi-independent agency called FCMAT, which is staffed by experts in education finance (often former district business officers themselves). California county offices of education also provide support services and financial monitoring for multiple districts.

However, the existence of intermediate agencies isn't always enough; they must also play an integral role in assuring districts' fiduciary responsibility. Michigan has fifty-six regional Intermediate School Districts (ISDs), which offer professional development, administrative assistance, and services for special student populations. However, many feel the ISDs could play a larger role in identifying and assisting districts in trouble. Said one informant, "If you look at a lot of districts who were insolvent, they had part-time business managers. So having an ability to connect with an intermediate school district and others to be able to review budgets and ask and answer questions may be helpful moving forward so that we prevent districts going into deficit." Other states also have intermediate agencies, like Ohio's regional Educational Service Centers and New York's Boards of Cooperative Educational Services. However, the missions of these agencies vary by state, and they usually focus on instructional programs and administrative services—not finances.

and even the political cover afforded by external experts in order to make necessary reductions and affect savings, especially as local resistance to cuts is typically an issue. Intermediate agencies are one way of providing these resources (see *Intermediate agencies to the rescue?*). Outside experts give the board leverage "[i]f a board is struggling [to do] the right thing and just needs the backup of a higher authority," said one such individual who has worked with district leaders in the past.

Contrast California with Michigan. In Michigan, districts in deficit are required to create a deficit elimination plan (DEP), which the state department of education subsequently approves (see *Spotlight on Michigan,* page 14). This is similar to the first step in California, and for some districts, simply triggering the review-and-planning process is enough prompting for them to identify and make necessary cuts. For example, the DEP approved for Michigan's Brighton Area Schools, if executed as written, would result in a budget surplus following the current 2014–15 school year. However, unlike in California, there is no assistance for districts writing their DEPs or oversight to ensure that they are implemented. Nor is there help to manage their finances in the interim.

2. Financial management: Who should control the purse strings?

If collaborative supports prove inadequate or the cause of distress is gross mismanagement, districts should then be subject to mandatory governance changes that bring in experts with expanded powers to oversee and act on fiscal matters—such as a financial manager who implements a district recovery plan. Financial managers should be appointed by the state, which is responsible for ensuring that they are well qualified (perhaps they were former chief financial officers of successful districts), compensated for their work (to guarantee commitment to the task), and removed and replaced if they prove unable to do the job.

Financial management typically takes the following form:

NEW PEOPLE

A financial manager takes on all responsibilities of the district chief financial officer and is given oversight over the local board and superintendent (though these remain in place and retain authority over nonfinancial decisions). The manager controls finances in the short term and simultaneously rehabilitates leadership (ideally anyway) so that the board doesn't run into trouble again once the manager leaves.

NEW POWERS

Moderate to high additional powers are granted to the appointed financial manager but not to the sitting board and superintendent. These are similar to the new powers granted to the state in the collaborative support phase, but now they lie at the district level. For example, the financial manager can do the following:

- Design a district recovery plan that is then approved by the board and implemented by the superintendent. The plan might include personnel adjustments, asset liquidation, and school consolidation or closure. (Although keeping the board in power seems like a recipe for conflict, stakeholders we interviewed stressed that the mere threat of the next stage—replacing the superintendent and taking over administrative control—is often enough to motivate district leaders to work in good faith with the new financial manager.)
- Require the district to submit to additional reporting and monitoring by the county or state.
- Represent the district when negotiating all employee bargaining agreements (replacing the board or board designee in negotiations).
- Retain stay-and-rescind power over all board actions that relate to district finances, including non-salary expenditures, purchase orders, employee contracts (if not bargained), bonds, and capital expenses.

Spotlight on Illinois: Local control, low capacity

With nearly nine hundred school districts, a budget still decimated by the 2008 financial collapse, a state department of education that has cut its staff in half, and nearly unfathomable unfunded pension liabilities, Illinois has little capacity to assist any but the districts in the direst of straits. Unfortunately, nearly 65 percent of districts had deficits in FY 2015.

> You have no capacity to really go into more districts. Even going into the few districts [we did] was incredibly challenging.
>
> **—Former official, Illinois State Department of Education**

Even worse, interventions to assist them are often unwieldy, frequently ad hoc, and let the state take a hands-off approach. Every year, the state uses five indicators to assign districts to one of four categories of financial risk.[33] Districts in the lowest categories receive technical assistance and are subject to further review. If the review determines that a district is at risk for insolvency, the state may ask it to submit a deficit reduction plan. In all other cases, the state simply continues to monitor district finances.

If the district cannot or does not follow the reduction plan, the state may install a Financial Oversight Panel (FOP). The district's board and superintendent stay in place, but the FOP, comprised of three school-business professionals and two local members, approves or vetoes all financial decisions. This group is in place for three to ten years.[34] It can recruit new leadership once the current leader's contract runs out, co-negotiate union contracts, play the "bad guy" so that leaders can make unpopular decisions, and petition the state for an emergency grant or loan—though the state may or may not grant it. Yet in the last decade, only eight districts have employed FOPs.

If the FOP isn't enough, or if the state doesn't believe one will work in the first place, it may remove and replace district leadership. Currently, two districts are at this stage. East St. Louis got a new superintendent in 2011, and North Chicago got a new chief education officer in 2012; both received emergency funds, as well.

Although giving state leaders discretion was meant to enable them to respond to diverse situations, informants report that this light-touch approach has been largely ineffective. Districts, they contend, would benefit from a rewritten law with stricter regulations around operational debt and a clearly defined system of interventions with automatic triggers for each step.

- Cancel any existing non-salary expenditure or purchase order without board approval.

NEW MONEY

The state can, with legislative or state board approval, grant small-scale advances against future revenue. These additional funds should only be awarded when districts have a clear spending plan in place that accurately matches revenues with costs.

Although this stage includes an expansion and addition of powers, it is only the new financial manager, not existing district leaders, who can exercise them, due to the fact that prior collaborative supports have failed. The financial manager can now do things that district leaders could always do, but chose not to, during the support phase. (For example, under normal circumstances, it is the board or its designee that negotiates teacher salaries and class sizes. If financial experts in the support stage determined that the district needed to make personnel cuts but the board failed to do so, the district enters the financial management stage. At this point, the manager takes over bargaining responsibilities from the board.)

Interventions at this stage might be coupled with low-level financial assistance if necessary, in the form of short-term loans from either the state or a private institution. However, policies should not encourage a pattern of cyclical borrowing from private lenders (see Appendix B for a cautionary tale). Instead, we recommend small-scale advances of expected state aid, as in Michigan.

This stage is a middle ground between districts helping themselves and full state administrative control. New leaders have financial powers that include and expand those of the district chief financial officer and also include some powers formerly reserved for the board and superintendent. Managers are tasked not just with handling district finances but also with building the capacity of the board and district administrators. Their responsibilities must be well-defined and their approach direct (for a counterexample, see *Spotlight on Illinois*). At the same time, managers do not supersede or replace the board completely. Informants said this balance of power is integral to helping districts maintain solvency in the future, because it combines immediate intervention with an exit plan so that locals are not completely dependent on outside support in the future.

3. Administrative control: When should leaders be replaced and districts bailed out?

Sometimes, a district simply cannot operate without an immediate and significant infusion of revenue, or the district's current leaders have proven unable or unwilling to follow the direction of a financial manager. In these cases, the district should undergo a leadership turnover: An appointed district manager replaces the superintendent, and a locally representative board serves in an advisory capacity. (This board may be the original local school board, with its power revoked, or a new board; see more below). At this point, districts are eligible to receive substantial state financial assistance, contingent on removing the superintendent and replacing the board (or at least removing its authority). The strings tied to revenue are deliberately distasteful so district leaders will see the emergency loan as highly undesirable. Full administrative control prevents the old leaders, who have shown no capacity for financial management, from continuing to mismanage funds while the district stays afloat with external funds. At the same time, it ensures that districts will stay solvent once they are bailed out.

Administrative control could take the following forms:

NEW PEOPLE

A state-appointed district manager takes on all responsibilities of the board and superintendent, retaining complete administrative control until local leaders demonstrate capacity (or are replaced by someone who does) and a significant percentage of the loan is repaid. The district manager may work with an external advisory board or other experts.

The locally elected board serves in an advisory capacity only.

NEW POWERS

Extensive additional powers are granted to the district manager, within the confines of state law. In general, the district manager can exercise new powers similar to those of the financial manager in the previous stage but can do so without approval. For example, the district manager can employ the following powers:

- Close, consolidate, or convert traditional district schools to charter schools without external or board approval.
- Liquidate district assets without external or board approval.
- Propose taxes or bonds to voters (in states where that is permissible).
- Immediately open employee and vendor contracts for negotiation. During collective bargaining with employee unions, the district manager may immediately implement the district's "last, best, and final" offer, should no agreement be reached.

NEW MONEY

Provide large-scale, long-term emergency loans.

Under complete administrative control, a state-appointed district manager acts as both board and superintendent, deciding on and then implementing all district policies. He or she has significantly expanded powers and can

Spotlight on Michigan: No early-warning light

Michigan has no early-warning system for identifying and helping districts in financial danger. Rather, state law prohibits deficit spending and sees an actual deficit as a mark of distress. However, there is no way to spot districts before they become deficit districts.[35] Once they do, they are required to develop a deficit elimination plan (DEP) and submit it to the state's department of education for approval. District leaders do so without collaborative supports, technical assistance, or governance changes. Yet, as one state employee stressed, "Financial responsibility starts at the local level."

> There's a significant leverage knowing that if it [a deficit elimination plan] doesn't work out, an Emergency Manager is where you could land. From a district choice perspective, that would probably be the last resort.
>
> **—Staff member of a statewide organization that provides support and finance training to districts**

If the district exhibits signs of mismanagement—missed payroll, noncompliance with its DEP, or a low credit rating—the governor can request a financial review by an external auditor and then by a financial review team, which can declare the district in a state of financial emergency based on a number of criteria such as large deficits, outstanding loans, or missed pension contributions. The state can also pronounce an emergency in districts that fail to comply with their DEP or refuse to cooperate with the financial review team. Once in financial emergency, districts must choose among four stringent options: receiving an emergency manager and undergoing receivership, entering into a consent agreement with the state, submitting to a neutral-party evaluation, or filing for Chapter 9.

Results of these interventions, which occur with few preliminary steps and which stakeholders refer to as "turbulent" and "chaotic," are mixed at best. District leaders do seem highly motivated to create and follow viable DEPs. However, as of December 2014, the MDE continues to monitor a total of fifty-five school districts that ended the 2014 fiscal year in deficit.[36] Emergency management also has not shown much promise, especially in the face of declining enrollment. Detroit Public Schools was placed under the control of an emergency manager in 2009. Six years (and four emergency managers) later, that school system faces a deficit of well over $100 million.[37] In 2012, the Muskegon Heights and Highland Park school districts received emergency managers, who subsequently chartered all of the schools. In Muskegon Heights, the emergency manager and charter board brought in Mosaica Education, a for-profit charter-management company, to operate the schools. Two years later, the charter board voted to end Mosaica's contract three years early because the schools still had a deficit (even after receiving an emergency advance in state aid to make payroll). Highland Park is still in the red, as well.

Thus, Michigan districts face two challenges: They are not subject to intervention until they are already "past the point of no return," and skipping straight to the administrative-control phase does not address major underlying financial issues.[38]

close, consolidate, or charter the schools, liquidate assets, propose taxes or bonds to voters, and immediately open employee contracts for negotiation. It's the final, most severe stage of a system designed to prevent districts from reaching it at all. (See *Spotlight on Michigan* for an illustration of why administrative control should be part of a larger process.)

Surprisingly, informants suggested that it is not effective or even necessary for managers to dissolve employee contracts completely. There are several reasons for this. First, overstaffing and its associated financial problems are tied to specific clauses in the contract, mostly those related to class size and/or teacher compensation. However, teachers are highly concerned about job security, and reopening the contract (rather than dissolving it and starting over) is often enough impetus to negotiate adjusted staffing levels, reduced or leveled salaries and benefits, or furlough days. Teachers continue to work under a contract (which is preferable to most), while the employee union must reconsider the specific contract provisions that are jeopardizing their employment.[39] Employee unions also know that district managers are not inclined to accommodate previously uncooperative employee groups, so making concessions during bargaining not only saves teacher jobs in the short-term but makes working conditions better for them in the long run, as well.

Second, financial problems are not always due to the contract but can instead be due to district leaders not exercising their full authority. For instance, districts might not be operating at the negotiated class-size maximums, but for whatever reason the superintendent has not made personnel cuts, consolidated classes or schools, or made other changes to maximize human resources. The new district manager can adjust class sizes, redistribute students and staff, eliminate unnecessary programs and services, and implement reductions in force without having to dissolve or even renegotiate existing agreements.

As such, it is not recommended that the district manager dissolve collective bargaining agreements outright. Rather, the manager should reopen them, but only if state law meets two conditions. First, the state must have binding arbitration laws, meaning both parties must accept the recommendations of a neutral mediator or panel should an agreement not be reached locally. Otherwise, there is no guarantee that an agreement can be negotiated in a timely manner or at all. Second, the state must have "last, best, and final offer" laws. Under normal circumstances, the old contract remains in effect during negotiations of a new one. However, if it is a major source of the district's financial problems, a district under administrative control should revert to the most recent version of the reopened contract that the union did agree to (the district's "last, best, and final offer") during the current round of renegotiations. This way, the district is not operating under its old, unsustainable bargaining agreement. Rather, for the time being it can operate under a contract that at least partially mitigates financial distress.

We recognize that in some states, the conditions of binding arbitration and a "last, best, and final offer" law might not be met. And, according to one interviewee, "There has to be some way to move the labor roadblock." In these cases, we recommend that district managers have statutory authority to dissolve bargaining agreements but take caution in using it.

Districts in this stage should also have a locally representative board—along with the appointed district manager—to foster buy-in. Additionally, local actors have knowledge about district context that state-appointed managers do not, which provides managers with insights

Closed for business?

Closing schools that prove dysfunctional is often best for students,[40] especially in small urban or suburban districts, where they can easily attend schools elsewhere. However, closing severely mismanaged, insolvent districts by shutting down all the schools within them and transferring students and funds to neighboring districts is another story. In large districts, where a complete district closure entails shuttering many schools across a sizeable geographical area, or in rural districts, where there are no nearby alternatives, closing all the schools at once would be extraordinarily disruptive. Most states understand well the quandary and have laws that keep schools open, but effectively close districts by replacing management and taking over operations when districts fail financially or even when they lose accreditation. (Granted, districts at this stage are at risk of shutting down anyway because of fleeing families.)

on what cuts are most feasible and sustainable. Finally, an exit plan is needed when external management departs. Building capacity via a local advisory board better enables districts to take back control over their own finances once the district manager leaves and sends the message that the state fully expects the board to do so.[41]

Districts that reach this stage may require massive and immediate revenue. It is crucial that emergency financial assistance is available once the district reaches a certain threshold of insolvency; otherwise, there is a risk that the schools must shut their doors (see *Closed for business?*). California law, by requiring that emergency loans have legislative approval, helps to safeguard the use of the funds against malfeasance and default. Illinois has similar policies. Granted, legislative approval might delay a desperately needed cash infusion, but given the amount of public dollars at stake, it is critical that elected officials scrutinize loans and their terms of repayment.[42]

It is true that giving districts emergency funds at all may be undesirable. However, the alternatives are (1) bankruptcy, which does not require a governance change (and gives a federal bankruptcy judge total authority over how a district can raise funds, often with detrimental consequences and without the permission of local or state officials), or (2) total insolvency (ceasing all operations). For this reason, emergency loans should be contingent upon administrative control. Without governance change, loans become true bailouts, as occurred in Philadelphia, where since 1998 superintendents have threatened to shut down the schools if the state did not provide emergency aid—and have kept their jobs in the meantime.

Final thoughts

Ideally, state policy should prevent districts from deficit spending and overcommitting expenditures into future years. However, state policies are often neither thoughtful nor strategic. Therefore, we leave policymakers with three key takeaways when interventions become necessary.

First, use the carrot—then the stick.

Although no single set of policy recommendations will help all districts restore solvency, for the majority of them, a sequence of interventions is the ideal. When preventive measures fail, states should first assist struggling districts by offering support and assistance, then provide financial management, and finally—if those measures fail—facilitate full administrative control (except in the cases of huge districts, such as Philadelphia and Detroit, which justify employing the last step first because they are too far gone and too large to close). Starting with a carrot—quiet, joint interventions that can prod districts in the direction of needed change—and keeping the state-takeover stick looming in the background can be quite an effective method. (Besides, state takeovers by themselves do not guarantee budget stability in the future.)

> From a governance perspective, an instructional perspective, and the educational experience of a child in a district that's insolvent and has been taken over by the state, [takeover] is so severe that you would do almost anything that you could to avoid it.
>
> **—Staff member, California Fiscal Crisis and Management Assistance Team**

Second, allow those who contributed to the mess to also contribute to its cleanup.

Allowing existing local leaders to participate in the "cleanup" of their own fiscally distressed district seems counterintuitive. Yes, fiscal distress often results from district leaders' slow or soft reactions to shrinking revenue. But those same leaders have a better idea of local context and need than do outsiders, as well as which actions will be tenable in their communities, even if they themselves don't have the will, resources, or expertise to pull them off alone. (Previous leaders who failed to address historical overstaffing, long-codified class sizes, or past mismanagement also contributed to the distress, and current local leaders may be eager for the opportunity to fix old problems.) That's why we recommend collaboration. Without outside intervention, even capable leaders who understand the causes of their fiscal problems are bound by opposition from employees, inaccurate enrollment projections, and pricey long-term obligations like preexisting loans and pension costs. Without local expertise, outsiders are an occupying army without knowledge or support.

Third, urge lawmakers to revisit regularly state laws pertaining to district insolvency.

A major factor driving the creation of California's system of tiered interventions was the bankruptcy of Richmond Unified School District in 1990. In subsequent years, every time a district reached the administrative control stage, state lawmakers revisited the policy, always with the input of representatives from the troubled district(s). Other states should likewise routinely examine their policies on district insolvency for shortcomings.

> Districts go insolvent when there are insufficient counter-pressures on them to stay fiscally solvent.
>
> **— Marguerite Roza, Georgetown University**

Increasingly, districts across the nation are grappling with severe financial difficulty. The strategies described herein are neither novel nor glamorous. They won't make for sensational headlines like financial crises in districts do. However, state and local policymakers who use them might avoid the devastation and demoralization that comes with district insolvency, which would be a great service (and boost) to the teachers, students, and parents whom they serve.

Appendix A: Designing, implementing, and supporting an early-warning system

The single most important strategy for handling district insolvency is to avoid it, which means practicing effective monitoring and prevention. The former entails identifying signs that a district might not meet its financial obligations in the future, such as risky investments, ill-advised vendor contracts, decisions made using poor (or misinterpreted) information, short-sighted collective bargaining agreements, and unqualified leadership. "Fiscal trouble" should not be equated with "already in debt." Monitoring should be coupled with some basic steps to prevent fiscal distress in the first place (for example, prohibiting operational debt).

Potential components of an effective monitoring and prevention system include the following:

Prohibit deficit spending, and do not let districts carry a deficit from one year to the next.

Districts in short-term trouble get into long-term trouble if they carry operational debt over from year to year. Prohibiting them from operating with a budget that's in the red is simply smart financial policy. In one rather egregious example, districts in Illinois can have negative balances in their operational funds for two consecutive years before the state reviews their finances.

Require budgets to include three- to five-year projections.

An easy way to present a balanced budget is to push obligations down the road, which can be prevented by requiring districts to make long-term projections. For example, furlough days are a short-term option to decrease personnel expenditures, but districts can't keep adding additional days indefinitely. Long-term projections force them to make sustainable choices.

Conduct multiple audits of district budgets and projections by a third party (county, regional, or state office) during the fiscal year. Audits should be conducted using a uniform instrument.

Once districts submit a balanced budget, a third party should review it to determine whether it is reasonable. California districts are required to submit two interim reports, and one at year's end, to the county education agency, which uses a standard instrument to certify it as positive (the district will meet current and future financial obligations), qualified (in danger of not meeting current or future obligations), or negative (unable to meet obligations). Contrast this to Michigan, where it falls to individual districts to monitor their own finances and report when they are already in deficit. In states where districts need not submit to multiple yearly checks, they should at the very least be required to report any midyear signs of danger.

Review investments to identify risks and potential large future losses.

Part of the audit should involve anticipation of future risk. In the early 1990s, several school districts in Orange County, California, borrowed more than $550 million to invest in a risky, county-managed portfolio that relied on derivatives and leverage.[43] As a result, the entire county declared bankruptcy and had to take out a $200 million emergency loan to meet its obligations. Financial advisors should review districts' existing investments and prepare them for what's down the road.

Limit the duration of operational contracts and establish triggers for automatic review of existing contracts.

Long-term vendor contracts are tempting during flush times—they're usually cheaper than short-term deals and are often for products or services that teachers and parents find appealing. They also lock districts into expenditures using cash they might not have in the future. For this reason, the duration of contracts should be limited, and the state or county should review (and potentially terminate) them when districts show other signs of distress.

Mandate a reasonable reserve requirement.

Clearly, districts would like to maintain sufficient reserves to guard against future budget shortfalls and funding instability. But if the state sets a low reserve requirement, districts may opt for short-term spending rather than long-term saving. In November 2014, for example, voters in California passed Proposition 2 to create a state emergency reserve fund for education, while capping the amount districts could keep in reserve for themselves at 3–10 percent of their annual budget.[44] Opponents are concerned that limiting local savings will make districts dependent on state funding and highly vulnerable to future economic fluctuations.

Discourage short-term, private stopgap loans, especially more than one.

Districts may require immediate funds to make payroll. We are reluctant to recommend prohibiting districts from securing private loans outright, because in some cases (such as distress due to one-time problems like mismanagement, corruption, or natural disaster), they are a single-use resolution to an interim setback. However, repeated borrowing can lead to cyclical debt, as one loan is used to pay off another, particularly if it allows district leaders to avoid making changes. The struggling Inglewood Unified School District recently got stuck in a cycle of taking out increasingly larger loans to pay back previous ones. Ultimately, it required a state-issued $55 million emergency loan and was placed under administrative control in fall 2012.

Provide accurate and timely enrollment data.

Districts can avoid overstaffing if they can accurately project how many staff members are needed at the start of the school year. To do so, states or regional agencies must collect and distribute enrollment data accurately, quickly, and more frequently than once a year. Michigan district budgets are based on current school-year enrollment (making it difficult to anticipate funding levels ahead of time), and the finance system is heavily centralized (per-pupil funding for districts is set by the state). According to a representative from a state association of school administrators, "Having the ability to set a budget at the beginning of the year, and knowing what that budget is so it doesn't change, is extremely important....Budgeting stability is imperative."

Promote district budget stability through a predictable calendar of state budget approval and revenue delivery.

Districts need the state budget prior to the start of the school year in order to anticipate revenue. They also need the state to deliver funding when promised. Irregular payouts from the state—made more insecure if legislatures do not approve budgets on time—create problems for districts that have regular payroll expenditures and may be forced to borrow from the bank against anticipated revenue. In Illinois, the state is still prorating general aid as a consequence of the recession; in California, the state never passes the budget on time. Districts in both states have trouble budgeting as a result.

Reconsider funding mechanisms so districts can react to change.

Sometimes districts simply don't have time to react to unanticipated major drops in enrollment. This is a problem in Michigan, where per-pupil revenue is cut immediately after enrollment goes down (as it has in two-thirds of the state's districts), while state law prevents districts from levying taxes. Informants cite this as a major reason that Michigan districts continue to be in financial distress, even those with emergency managers.[45]

Provide districts with access to experts, and don't penalize them for asking for help.

Leaders don't want their districts to fail, but sometimes they don't know they're in trouble and have no one to ask for help; they may also fear that requesting assistance implies incompetence. Districts should have access to financial experts, available to them at little to no cost through the state or regional education agencies or a third party.

Appendix B: Spotlight on California: A successful tiered system

California is one example of a successful system of tiered interventions. The monitoring phase identifies districts in distress early, and because of prohibitions against deficit spending and requirements that districts submit both interim and final budgets, low-level collaborative supports are almost always enough to ensure future fiscal stability. The set of policies, originally encapsulated in Assembly Bill 1200 (1991), are routinely reviewed and updated.

Proactive monitoring

Under AB 1200, each county superintendent has fiscal oversight responsibility over districts in that county (fifty-eight county offices oversee 1,028 districts); the state superintendent then oversees the county offices. Districts report their financials three times to the county, completing two interim reports and a final balanced budget for the current and next two years. Districts are not allowed to operate with a deficit and must maintain a 3 percent reserve. The county superintendent certifies district budgets as positive, qualified, or negative using standards created by the state school board. A positive certification means the district will meet its current and future obligations, a qualified certification means it may not meet them, and a negative certification means it is unable.

Collaborative supports

If a district receives a qualified or negative certification, the initial first-level interventions are collaborative supports. The county office of education can make direct recommendations on how to reduce expenditures, appoint a budget review committee, assign a professional fiscal advisor, call in the state Fiscal Crisis and Management Assistance Team, require the district to submit a fiscal recovery plan (often developed with the assistance of the review committee or consultant), prohibit certain non-salary expenditures, cancel purchase orders, and/or approve certain debts such as short-term private loans. These interventions are low-level governance changes or minor expansions of the powers of county (not district) officials. The review committee and consultants are advisory only and do not replace or supersede district leaders; rather, they provide technical assistance so that districts can project revenue and cut costs.

Financial management

Officially, school boards are not required to follow the recommendations of outside experts. If, however, the county superintendent feels that district leaders are not cooperating or doubts that the fiscal recovery plan will succeed, he can take more drastic measures (or give the fiscal advisor broader powers). These second-level interventions occur only in negatively certified districts and include imposed revisions to the district budget, so long as they do not conflict with existing collective bargaining agreements. The county superintendent can also exercise stay-and-rescind power over the school board or allow the advisor the same power, meaning he may prohibit the local board from voting on measures, including collective bargaining agreements, that would undermine the district's ability to meet its financial obligations.

Administrative control

If first- and second-level interventions fail or the district is in so much trouble that it cannot make the next payroll, the state provides an emergency loan (with the approval of the legislature) with many strings attached. The state superintendent appoints an administrator to assume all the duties of the school board (which then takes an advisory role only) and fires the superintendent. The administrator creates and implements a plan to return the district to solvency while the district repays the state loan using bonds sold to private investors (which it repays to its investors over twenty years). The board can regain control gradually and only with approval from the state superintendent after it demonstrates capacity in financial management, pupil achievement, personnel management, facilities management, and community relations. The state administrator maintains control in the interim. Once the board is fully reinstated, a state trustee with stay-and-rescind power replaces the administrator and remains until the loan is repaid in full and the state is convinced the district will follow its fiscal recovery plan.[46]

Two decades of success

Since 1990, only nine districts have required an emergency loan: Richmond (1990), Coachella Valley (1992), Compton (1993), Emery (2001), West Fresno (2003), Oakland (2003), Vallejo City (2004), King City (2009), and Inglewood (2012). Only four—West Fresno, Vallejo City, King City, and Inglewood—needed loans large enough to compel administrative control; the smaller size of the other loans required a trustee only. After the first interim report of the 2013–14 school year, there are only eight (out of more than one thousand) districts with a negative certification and a further forty-one with a qualified certification.

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33 In 2015, thirty-eight districts of 860 fell into the lowest category: "financial watch."

34 Because it's the state's largest district by far, with a unique and complex set of financial problems, these rules do not apply to Chicago. Instead, after a financial crisis in 1979, the city was placed under a school-finance authority for thirty years, far longer than any other oversight panel assembled. It is now under direct mayoral control.

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41 Both the manager and the advisory board are integral components at this stage. In Philadelphia, an advisory board called the School Reform Commission replaced the school board in 2001, but the superintendent remained and the district's financial woes continue.

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