

SECTOR COMMENT

# Michigan School Districts Under Pressure: Outlook Remains Negative

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**Summary Opinion**

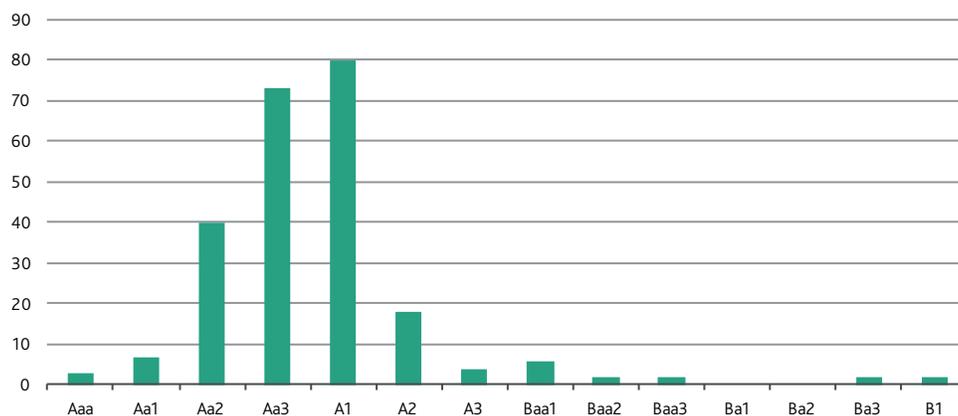
School districts in the State of Michigan have faced unprecedented fiscal stress over the past few years stemming from direct funding cuts, enrollment declines, and limited revenue and expenditure flexibility. Combined, these factors have contributed to a significant narrowing of financial reserves for a large number of districts, which has led to a disproportionate share of rating downgrades in the sector. We expect the majority of districts to continue to manage challenges and maintain fiscal stability. However, additional rating downgrades may occur for districts under immense pressure as well as for those that have exhausted options to cut expenditures. Districts with rapidly declining enrollment and waning operating revenue face the most significant challenges. While state per pupil aid will likely not decline further in the near term, these districts will remain challenged in the absence of stabilized enrollment or increased state aid.

**Sector Overview**

Moody's maintains long-term general obligation ratings on 239 Michigan school districts. The ratings span from Aaa to B1, with a median rating of Aa3.

EXHIBIT 1

**Distribution of Michigan School District Ratings**



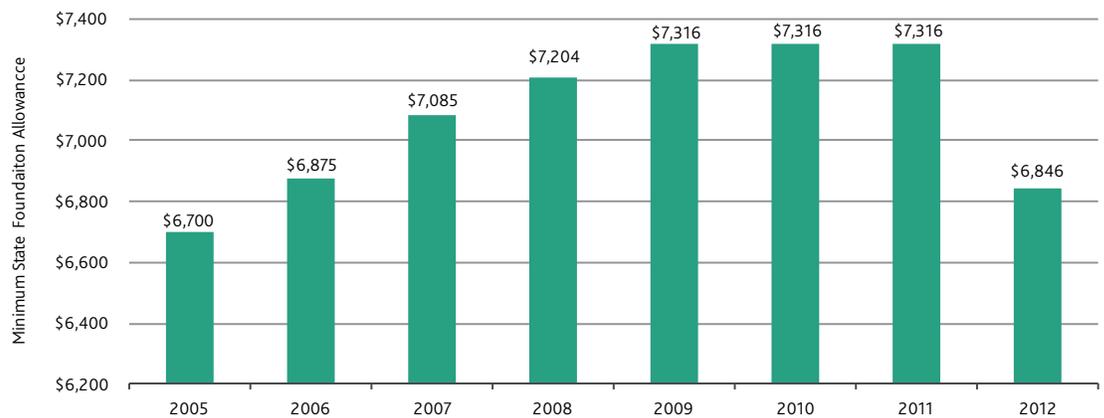
Source: Moody's Investors Service

## School District Funding is Dependent on State Foundation Allowance

School district funding is provided in the form of a per pupil foundation allowance, which is established for each district in the state's annual budget. The foundation allowance is funded with a mix of locally-raised property tax revenues and state aid. School districts generally levy up to 18 mills on non-homestead property and the state provides funding to make up the difference between the amount generated by the local property tax levy and each district's foundation allowance. Favorably, this means that district revenues are not significantly impacted by declines in taxable value, which have been considerable throughout the state over the past five years. However, districts are susceptible to budgetary pressures at the state level that have resulted in stagnant funding and, most recently, a large decline (see Exhibit 2).

EXHIBIT 2

### State Funding Flat Before 2012 Decline



Source: Michigan Department of Education

In fiscal years 2010 and 2011, the State of Michigan faced shortfalls in its school aid budget of \$450 million and \$184 million, respectively.<sup>1</sup> The state partially filled the gap with federal funds from the American Recovery and Reinvestment Act (ARRA), precluding the need to dramatically reduce school funding in those two fiscal years. However, stagnant state funding did not necessarily keep pace with districts' growing expenditures, particularly those related to employee pensions.<sup>2</sup> In fiscal 2012, ARRA money was no longer available to offset state revenue shortfalls, and the state reduced the per pupil foundation allowance by \$470, or roughly 6%. School districts across the state, having limited options to raise revenues, were forced to absorb the cut with available reserves, significant reductions in expenditures, or some combination of the two.

<sup>1</sup> Source: All school funding information has been obtained from the Michigan Department of Education unless otherwise noted. State sales tax revenue is the primary funding source of the state foundation allowance and declines in state sales tax collections during the recent recession contributed to the shortfalls in state funding for school aid.

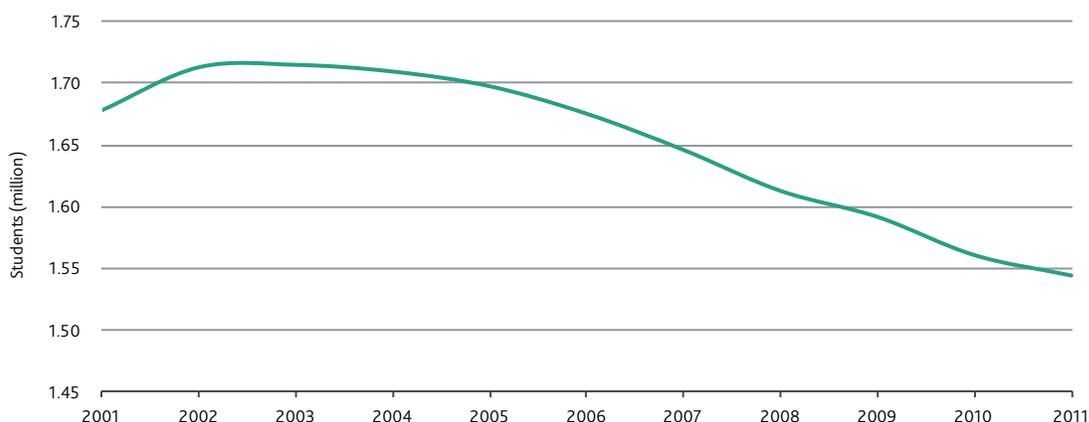
<sup>2</sup> For additional information regarding school aid funding in recent years as well as school districts' pension obligations, see Moody's Sector Comment "[Michigan's FY 2013 Budget Increases Funding for Some School Districts, but Uncertainty Remains Regarding Pension Costs](#)" published July 11, 2012.

## Falling Enrollment Results in Loss of Revenue

As school funding is provided on a per-pupil basis, enrollment trends have a direct impact on operating revenues. Statewide, enrollment in Michigan school districts has steadily declined since fiscal 2004 by an average of 1.3% annually and a total of 10% (see Exhibit 3).<sup>3</sup> The decline in enrollment mirrors the state population trend over the prior decade. Between the 2000 and 2010 census periods, the State of Michigan's total population declined by a modest 0.6%.<sup>4</sup> However, population loss within the under-18 age group was a substantial 9.7% (see Exhibit 4).

EXHIBIT 3

### Michigan Statewide Enrollment



Note: Data points represent student counts conducted in the fall of each referenced calendar year and include enrollment in public school districts as well as public charter schools

Source: Michigan Department of Education MI School Data

EXHIBIT 4

### Total vs. Under-18 Population in Michigan

	2000	2010	Change
Total Population	9,938,444	9,883,640	(0.6%)
Under-18 Population	2,595,767	2,344,068	(9.7%)

Source: 2000 and 2010 US Census

While some individual districts have benefited from enrollment gains, many more have experienced enrollment declines on par with, or in excess of, the statewide trend and are expected to contend with further declines going forward. Of the 239 rated school districts, 63 (26%) have experienced an overall gain in enrollment from fiscal 2004 through fiscal 2012, while a much greater 176 (74%) have realized declines. A total of 94 rated school districts have experienced losses of greater than 10% from fiscal 2004 through fiscal 2012.

<sup>3</sup> Source: All information regarding school enrollment has been obtained from the Michigan Department of Education's MI School Data unless otherwise noted.

<sup>4</sup> Source: All information regarding population has been obtained from the US Census Bureau unless otherwise noted.

## Limited Ability to Increase Operating Revenues Coupled with Ongoing Expenditure Pressure

Per state law, individual districts are precluded from seeking voter support of additional levies that would provide new, locally-raised operating revenue in excess of the foundation allowance.<sup>5</sup> Local property tax millage rates are generally capped at 18 mills levied on non-homestead property. Certain districts have retained additional mills that had been approved by voters prior to 1994, but those districts are equally unable to further increase these additional levies going forward.

### Enhancement Levies

Intermediate school districts (ISD), which are comprised of a number of individual school districts within the same county,<sup>6</sup> may levy additional taxes to support general operations of each member district. In order to seek voter support of such a tax increase, defined as an enhancement levy by the state, individual school boards representing at least a 51 percent majority of the student population within the ISD must approve such a measure. The proposal is then placed on the ballot within the ISD.

Such approval can be difficult to obtain because a district's taxpayers may end up paying more in property taxes than that district would receive in revenue on a per pupil basis. Taxpayers within a district with proportionately higher property values but lower enrollment could pay more pursuant to the new tax than the district would receive, once revenue is divided up by the ISD.

Enhancement levies can also be dedicated to specific purposes, such as special education. For example, residents in the Washtenaw County ISD voted to renew a special education levy of approximately 1 mill in May 2011. Residents in the Jackson County ISD voted on August 7, 2012 to increase an expiring special education levy from 0.9 to 1.55 mills, providing an estimated \$2.7 million in new revenue to be allocated to the twelve public school districts within the ISD. The new levy is in place through 2017.

As personnel costs represent the majority of school district budgets, the primary option for offsetting revenue losses is to reduce staff. On average, personnel costs comprise nearly 97% of school district General Fund operating expenditures, with contributions to the state's public school employer pension system alone representing over 20% of payroll expenditures in fiscal 2012. Reducing personnel can be a challenge as enrollment declines may not be large enough to completely eliminate a class. Furthermore, districts may be constrained by provisions in collectively-bargained contracts that stipulate staffing levels and compensation.

## Large Number of Rating Downgrades Associated with Financial Pressure

Persistent revenue challenges and a limited willingness or ability to reduce expenditures accordingly has contributed to a large number of rating downgrades to Michigan school districts over the past few years. Between January 2009 and September 2012, a total of 88 rating downgrades have occurred. These downgrades have involved 58 public school districts, or nearly a quarter of the 239 districts we rate. Of the 58 affected districts, 22 have been downgraded multiple times over that time period. The number of downgrades has also increased year to year, with those in 2012 having already exceeded those of 2011 as shown in Exhibit 5 below.

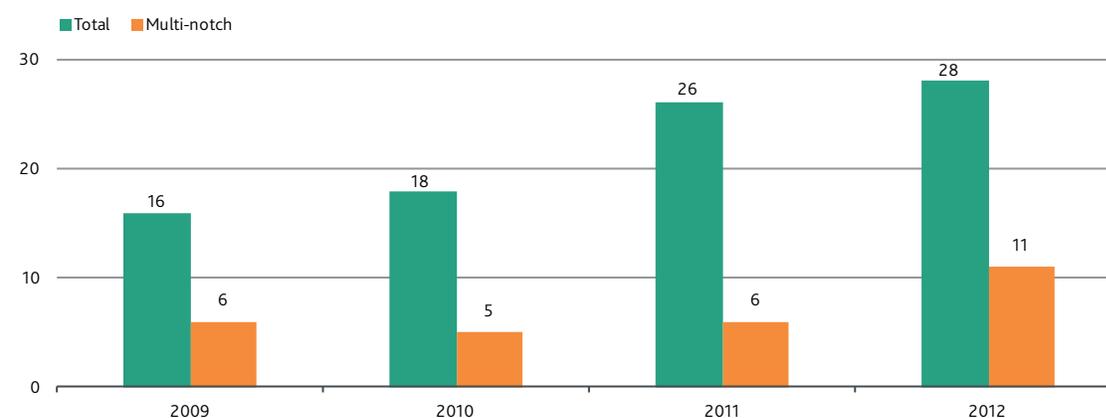
<sup>5</sup> Districts can seek voter support of sinking fund levies to finance capital expenditures.

<sup>6</sup> An ISD can also span multiple counties, as is typically the case in the northern part of the state.

## EXHIBIT 5

**MI School District Downgrades**

(January 2009 through September 2012)



Source: Moody's Investors Service

Further, Michigan school district ratings have moved downwards at a disproportionate rate compared to other local governments in Michigan and the rest of the nation. Michigan school districts comprise 68% of our general obligation local government ratings in the state, but make up 76% of Michigan local government rating downgrades since January 2009.<sup>7</sup> The difference is more pronounced on a national basis. Exhibit 6 shows that the share of Michigan school district downgrades is at least three times greater than both the sector's share of total US local government ratings and its share of US school district ratings. The share of multi-notch downgrades is over four times greater than the share of US local government ratings and over six times the share of US school district ratings.

## EXHIBIT 6

**Share of Downgrades is Disproportionate to Share of Ratings**

(January 2009 – September 2012)

	Michigan School Districts	Michigan School Districts as a Share of:		
		MI Local Governments	US Local Governments	US School Districts
Rated entities	239	68%	3%	7%
Rating downgrades	88	76%	9%	24%
Multi-notch downgrades	28	76%	14%	45%

Source: Moody's Investors Service

### School District Rating Downgrades Concentrated in Economically Challenged Southeast Region of the State

School district downgrades have been geographically concentrated in the southeastern quadrant of the state's lower peninsula. Nearly 80% of all Michigan school district downgrades since January 2009 have been applied to districts located in this region. The share of downgrades is disproportionate to the 56% of rated Michigan school districts located there (see Exhibit 7). This area of the state is largely comprised of the Detroit metropolitan region, many areas of which have been challenged by steady population and enrollment declines. Between 2000 and 2010, total Detroit metro area population fell

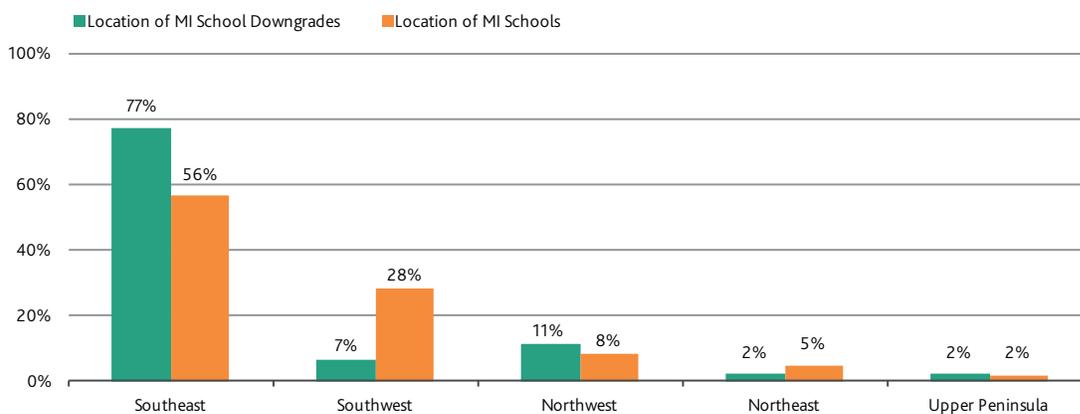
<sup>7</sup> For purposes of this report, "local governments" refers to school districts, cities (including villages and townships), and counties.

by 3.3%, while that of the under-18 age group declined by 11.3%. The southeast region also includes the metropolitan areas of Ann Arbor, Flint, Lansing and Saginaw. Like Detroit, these communities have also contended with various challenges brought on by the recent recession, including elevated unemployment as a result of contraction within the manufacturing and automotive industries.

EXHIBIT 7

### MI School Ratings and Downgrades by Region

(January 2009 through September 2012)



Source: Moody's Investors Service

## Outlook Remains Negative for Michigan School District Sector

Based upon these persistent fiscal challenges, the outlook for the Michigan school district sector remains negative going forward. Additional downgrades are likely to occur in the near term, especially among those districts that have realized significant narrowing of financial reserves that has left them with very little flexibility to offset further declines in revenue. Many districts that have to date maintained credit quality could experience rating pressure, particularly those that have reduced fund balance reserves and have already implemented expenditure reductions. Given the sizeable reduction in the state foundation allowance, we expect to see further loss of reserves as fiscal 2012 financial audits are finalized. Presently, 43 Michigan school districts have negative outlooks assigned to their ratings, approximately 18% of those rated.

Furthermore, the state's new budget included only modest growth to school funding for fiscal 2013. A \$120 per pupil increase to the state minimum foundation allowance from \$6,856 to \$6,966 pales in comparison to the \$470 reduction that was enacted in 2012. Districts with a foundation allowance in excess of \$6,966 per pupil received no increase in basic funding. Despite these concerns, three-fourths of rated schools have maintained stable credit ratings since January 2009 and we expect the majority of these to continue to do so. Districts expected to maintain credit ratings tend to benefit from relatively stable enrollment and strong management commitment to keeping expenditures in line with available revenues.

## A Small Number of Districts are Under Severe Stress

A handful of Michigan schools have operated under an even greater degree of financial stress in recent years and are expected to continue to do so in the coming year. These districts have faced extremely high rates of enrollment decline with no clear indication that the trends will reverse anytime soon.

These districts face the challenge of making further expenditure reductions to balance budgets while maintaining adequate programming in an effort to retain students. Five of these most pressured districts are currently rated below investment grade<sup>8</sup> (see Exhibit 8) and another ten are rated below the A-rating category (see Exhibit 9).

## EXHIBIT 8

**Michigan School Districts with Below Investment Grade Ratings**

District	GO Rating	Outlook	Most Recent Rating Action/Report	Total Change in Enrollment, 2004-2012
Clintondale Community Schools	Ba3	Negative	April 27, 2012	(5.3%)
Ypsilanti Public Schools	Ba3	Negative	September 5, 2012	(22.9%)
Detroit Public Schools *	B1	Negative	July 20, 2012	(56.8%)
Pontiac City School District	B1	Negative	April 25, 2012	(49.1%)
Detroit Academy of Arts and Sciences **	Caa2	Negative	April 16, 2012	(47.5%)*

\*Under administration of a state-appointed Emergency Financial Manager

\*\* Public charter school

\*\*\* Includes closure of high school effective fiscal 2012

Source: Moody's Investors Service and Michigan Department of Education MI School Data

## EXHIBIT 9

**Michigan School Districts with Ratings in the Baa Category**

District	GO Rating	Outlook	Most Recent Rating Action/Report	Total Change in Enrollment, 2004-2012
Bedford Public School District	Baa1	Negative	July 20, 2012	(12.1%)
Brighton Area Schools	Baa1	Negative	March 5, 2012	(16.0%)
Fitzgerald Public School District	Baa1	Negative	October 2, 2012	(10.9%)
Harper Woods City School District	Baa1	Negative	April 17, 2012	6.8%
Pinckney Community Schools	Baa1	Negative	October 4, 2012	(16.7%)
Pinconning Area School District	Baa1	Negative	August 8, 2012	(23.7%)
Perry Public Schools	Baa2	Negative	June 4, 2012	(22.0%)
Van Dyke Public Schools	Baa2	Negative	May 3, 2012	(27.8%)
Mt. Clemens Community School District	Baa3	Negative	February 23, 2012	(49.7%)
Oak Park School District	Baa3	Negative	April 3, 2012	(23.7%)*

\* Through 2011. Oak Park regained almost all lost enrollment in fiscal 2012 due to creation of new alternative education and vocational programs

Source: Moody's Investors Service and Michigan Department of Education MI School Data

Of the fourteen public school districts rated Baa1 and below, seven had negative General Fund balances as of the close of fiscal 2011. For the remainder, financial reserves have narrowed substantially and may fall into a deficit position within the very near term. All but one of these fourteen districts are located in the southeastern region of the state, with nine specifically located in the Detroit metropolitan statistical area.

<sup>8</sup> This number includes four public school districts and one public charter school. While public charter schools have no taxing authority, they receive a per pupil foundation payment from the state. That payment is made up entirely of state revenues, which are specifically pledged to repayment of outstanding bonds. While the rating is not a general obligation rating, the use of state aid revenues for operations and debt repayment means that public charter schools face the same credit pressures as public school districts, namely cuts in state revenue and declines in enrollment.

## Competition for Students is Creating Further Stress

Negative enrollment trends driven by out-migration are exacerbated by growing competition for students. Many districts now participate in the state's Schools of Choice program, which entitles them to accept students residing in other public school districts. This can result in a movement of students out of lower performing districts, with the revenue associated with those students following them to their district of choice. Furthermore, an increasing number of families are opting to enroll students in a growing number of public charter schools. More than 250 public charter schools now operate within the State of Michigan, with a large number of these located in or near the Detroit region.<sup>9</sup> The City of Detroit alone contains the second largest concentration of charter schools in the nation, with an estimated 41% of students in the city having attended a charter school in the 2011-2012 school year.<sup>10</sup>

In light of this competitive environment, significant enrollment losses can be difficult for a school district to manage, potentially creating a vicious cycle of revenue declines and budget pressures. As students leave a district, revenues typically fall because of Michigan's per-pupil funding structure. This may drive the district to cut expenses in response by reducing teaching staff and programming to balance the budget. Such cuts, however, could exert additional pressure on meeting the district's performance goals, and induce even more students to seek alternative schooling, thereby perpetuating the downward cycle.

### State Oversight of Financially Stressed School Districts

The State of Michigan provides some degree of oversight for school districts in significantly weak financial conditions. Any school district that maintains a negative General Fund balance or budgets to close the next fiscal year with a negative balance is required to submit a deficit elimination plan to the state's Department of Education. Deficit elimination plans must detail how a district expects to eliminate a General Fund deficit in no more than five years. If a district fails to submit a plan to the state or if the state rejects the revenue and expenditure assumptions in a plan, the Department of Education may immediately withhold state aid payments from that district until either a plan is submitted or amended. In April 2012, the Department of Education withheld payments to the Pontiac City School District pending submission of an updated deficit elimination plan that detailed more significant expenditure reductions than had earlier been proposed.<sup>11</sup> State aid payments resumed in June 2012 following state approval of an amended plan.

The state can also provide oversight via the appointment of an Emergency Financial Manager (EFM) per Public Act 72 of 1990. EFMs have the authority to make financial decisions on behalf of the local government in an effort to address fiscal pressures. Detroit Public Schools is the only school district we rate that is currently under the oversight of an EFM. A manager was first appointed to the district in March 2009. Two other districts, Muskegon Heights and Highland Park, were appointed EFMs in 2012.

In March 2011, the state enacted Public Act 4, which expanded the conditions under which the state could initiate a financial review of a stressed municipality and also granted appointed personnel additional powers to address fiscal concerns. Public Act 4 was repealed by voters in November 2012, resulting in permanent reinstatement of Public Act 72 per opinion of the state's attorney general. Pending litigation regarding the permanent reinstatement of Public Act 72 could result in reduced state oversight of pressured school districts and other local governments going forward.<sup>12</sup>

<sup>9</sup> Source: Michigan Department of Education MI School Data

<sup>10</sup> Source: National Alliance for Public Charter Schools

<sup>11</sup> See [Moody's Weekly Credit Outlook](#) published April 23, 2012.

<sup>12</sup> See [Moody's US Public Finance Weekly Credit Outlook](#) published November 8, 2012.

## Conclusion

Ongoing fiscal pressure for Michigan school districts has resulted in a large and disproportionate number of rating downgrades over the past four years. The number of downgrades has accelerated as declining revenues have resulted in steady weakening of many districts' financial positions. Given limited flexibility to close budget gaps, further rating downgrades are expected going forward. Districts most likely to preserve credit quality are those that have benefited from greater enrollment stability, as well as a capacity and commitment to control expenditures and maintain satisfactory financial reserves.

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