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# The Phantom Menace: Policies that Protect Districts from Declining or Low Enrollments, Drive Up Spending, and Inhibit Adaptation

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While districts are struggling to provide educational resources for the students in their charge, many actually continue to fund students that do not exist. This paper discusses how and why districts fund “phantom students,” and provides recommendations to end this practice.

## INTRODUCTION

Many state education leaders are taking a fresh look at their school finance formulas in hopes of finding ways to contain costs and get more for their dollar. That is an understandable response given that education is the largest item on most state budgets.

Some are searching for *efficiencies* by reworking transportation formulas, or zeroing in on special education eligibility, or pushing to merge districts so as to contain costs. Others see opportunity by seeking to improve *productivity* in schooling and are restructuring their formulas to invest more in digital learning, charter innovations, and information systems. But many state leaders are overlooking a common state formula practice that inhibits both efficiency and productivity – namely, the practice of funding students who do not actually attend school in funded districts or what this chapter will call “phantom students.”

*Policies that fund phantom students are policies that deliver more funds to districts than would be justified by their actual enrollment. These policies can take the form of:*

- Declining enrollment protections;
- Provisions that hold districts harmless for loss of students to charters;
- Subsidies for small districts; and
- Minimum allotments for categorical allocations.

In each case, the affected districts receive funds in excess of what they would receive if only the students on their rolls were funded. All told, these kinds of provisions drive more funds to some districts than are warranted under the total state enrollment figures.

As we describe in this paper, an obvious downside is that these policies result in higher spending for effected districts and fewer available funds for all other districts. These allocations also insulate district leaders from making the tough (and often productivity-enhancing) adaptive changes in the way they deliver services to better meet the size of the student bodies that do exist. In other words, the policies intended to “protect” these districts are actually inhibiting the kinds of incentives that would normally drive change and adaptation within districts as their enrollments fluctuate.

Politics is often the real driver behind these costly policies, but policymakers tend to justify them with one of two failed assumptions. The first assumption is that all districts need a minimum amount of revenue in order to operate and that below some size the costs of programs and schools are inherently higher. The second assumption is that districts face numerous fixed costs that cannot be reduced when enrollment declines. Lurking behind both assumptions is the idea that there is only one way to serve students (e.g. a prescribed mix of staff supporting schools organized in a traditional manner). Similarly, there is the notion that districts have no alternative but to purchase those inputs in order to deliver appropriate services.

This paper begins with a short section describing the typical operational relationship between expenditures and revenues in districts to set the stage for how state allocations affect spending behavior in districts. Next, we describe each of the four policies funding phantom students and dig deeper into the rationale for the policies, why the rationale doesn't necessarily hold true, and the expense of the policy.

For each, we also highlight the ways in which the allocation is driving up costs and inhibiting more adaptive, productive spending choices. Finally, we suggest some practical policies states might adopt to help districts deal with enrollment fluctuations while not creating rewards for small or declining enrollment districts.

## THE POLITICS OF BUDGETING AND THE ECONOMICS OF ENROLLMENTS

State policymakers often try to use "costs" as the basis to determine funding levels and allocations for districts. The truth is the relationship between the costs at the district site and revenues is somewhat interdependent. A district with vastly more funds per pupil than its neighbors can obviously afford to offer more or better services to its students, perhaps in the form of extracurriculars, more individualized learning time, etc. It also is the case that the very cost of delivering the same services as neighboring districts can become higher.

In other words, higher revenues can work to drive up the "price" of services to students in districts. Here is how it works: Each year, districts are under pressure to have expenditures roughly match revenues. If expenditures are projected to come in higher than revenues, the district will need to reduce its spending to match its funds. However, if revenues are projected to come in significantly higher than expenditures, districts still have a hard time squirreling the surplus away.

As one of the authors has noted elsewhere, too much surplus may suggest to employee unions that a raise is due and to parents that class sizes should shrink.<sup>i</sup> There is immense political pressure for positive surpluses to be quickly soaked up in a manner that raises the cost of services on a per pupil basis without fundamentally changing the delivery of those services.

Unfortunately, this works well on the way up but not on the way down. Many a district leader has found that raising salaries and reducing class sizes is politically quite a bit more palatable than vice versa. In times of declining revenue and shrinking enrollment, districts suddenly find themselves with unsupportable cost structures.

Into these politics plays another issue: The cost to a district of enrolling a few additional students. If a district is growing and receives allocations on the basis of enrollment, they will typically find that the new students generate a surplus.

To illustrate, consider a simplified, hypothetical example. Assume a 10,000 student district that has an enrollment increase of 200 students from one year to the next and that state and local funding provides \$10,000 per student enrolled. As Table 1 illustrates, the school district will receive \$2,000,000 in additional revenues.

However, under a typical district schooling structure, direct costs are not likely to increase as dramatically. Even assuming that all the students are placed into newly-created classes with relatively well-paid teachers, the additional costs are likely to be less than half of the additional revenues generated. Assuming that no new schools are built to house these students, i.e., that these are marginal students, the district will have a large surplus available to be spent on other things – such as new programs across the district, class size reductions, and raises.

i Jon Fullerton, "Mounting Debt," *Education Next*, Winter 2004, Volume 4, No. 1.

Table 18.1. Surplus Generated by Enrollment Growth.

<b>Revenues</b>	
Revenue per student	\$10,000
Additional students enrolled	200
Total Additional Revenues	\$ 2,000,000
<b>Expenditures</b>	
Class size	25
Additional teachers needed*	8
Compensation per teacher	\$100,000
Books and supplies per student	\$200
Total Additional Expenditures	\$840,000
Surplus	\$1,160,000

Now consider what happens when the same district shrinks by 200 pupils. Assume the district reduces its teaching force by eight teachers and no longer pays for the supplies of these students. It is able to cut \$840,000 out of its expenses – but it is still losing \$2,000,000 of revenue. If the \$1.2 million surplus from prior growth was indeed spent across the district and not simply on those 200 students, the districts will need to make general budget reductions or “cuts due to declining enrollment.” The tendency of districts to spend all that they have creates a felt non-symmetry around enrollment growth and decline.

The same forces have dominated the thinking on small districts, namely that services in small districts should be delivered in much the same way as those in large districts. Small districts, the argument goes, still require a full time librarian, counselor, nurse, physical education teacher and so on. Thus, some minimum level of fixed costs is unavoidable.

As a result, the discourse around enrollment loss and small district expenses often focuses on the high “fixed costs” that districts face.<sup>ii</sup> However, this is a misunderstanding of what fixed costs are. Few in other industries consider personnel costs as fixed. (Personnel costs make up the majority of district expenditures.) Administrations could shrink, pay raises could slow, and schools could be closed. In the case of small districts, many services could be purchased in smaller increments with part time staff or by contracting with service providers (e.g. online learning, contract nursing service).

That it is technically possible to operate districts at different sizes is clear. A scan of the 14,000 or so districts in this country shows that they can and do operate at all different sizes, most of which are much smaller than the urban districts perpetually in fiscal trouble. Take California, where the state contains the Los Angeles Unified School District (more than 600,000 students), but also Fresno (74,000), Pasadena (20,000), and hundreds of districts with less than 10,000 students – all of which are providing schooling services.

For district leaders, facing small or reducing enrollment can be painful. And so, state law makers have enacted phantom student policies to help districts cope...but at what cost?

ii For an example of this, see Massachusetts Association of School Superintendents Charter School Task Force, *Beyond Discord: Resolving the Tensions between Charter and Public Schools*. March 2005, Appendix C.

## #1 State Finance Formula Protections for Districts with Declining Enrollment

Recently, districts in Tucson, Cleveland, Newark, Philadelphia and many others faced enrollment declines and a corresponding dip in revenues as a result. A few years ago, Baltimore, Seattle, and Portland, Ore., topped the list of districts in fiscal chaos created by falling enrollment.

Enrollment shifts are certainly part of the landscape. At any given time, just as many districts may be facing enrollment drops as are seeing enrollment gains. But each time, district leaders seem caught off guard with the red ink. They find their district dipping into reserves, paring down extracurriculars, and making out-of-cycle pleas for rescue funding in order to avert salary freezes, seniority-based layoffs or school closures.

As alluded to above, the problem isn't really fixed costs; rather, it is that shrinkage is painful. Districts structure their expenditures in ways that are not responsive to the revenues, which can push the system into chaos when unaddressed. But instead of seeking a solution to the problem on the district side, some leaders use enrollment declines to claim big budget gaps are not their fault. For them, the problem is seen as the declining enrollment, not the expenditure structure. As one study finds, "declining-enrollment districts are more likely to be fiscally unhealthy" (Perry, Oregon, and Williams, 2006). Put this way, one might conclude that financial stress is inevitable amidst enrollment declines, and thus must be "treated" with an infusion of state funds.

And so it goes. States attempt to ease the pain by jumping in with extra funds for districts with enrollment drops.

In California, core allocations to districts (known as the Revenue Limit) are made to districts on the basis of average daily attendance. For the past decade or so, when enrollment declined, the allocation was made on the basis of the previous years' average daily attendance.<sup>iii</sup> While this was only a one-year reprieve for districts, the amount spent is substantial. In 2005-06, the total cost of this protection was \$402 million or about \$111 per ADA in declining enrollment districts.<sup>iv</sup> Taken together, last year the phantom students funded by California's declining enrollment provision would have been California's third largest district – larger than Long Beach, Fresno, or San Francisco.<sup>v</sup>

In Colorado, districts receive funding for the higher of current enrollment or the average of the last five years' enrollment.<sup>vi</sup> A recently-proposed bill would have further leveled funding up for declining enrollment districts to give them more years to "develop efficiencies."<sup>vii</sup> But in a world of limited state resources, extra funds for the 109 declining enrollment districts in Colorado means fewer funds for other students.

In other states, these policies can take the form of one-off allocations made to protect larger city districts as students disappear. Pennsylvania, for instance, funds the Pittsburgh and Philadelphia districts on a different formula basis than all other districts in the state. This effectively grandfathers them in under a higher expenditure structure than their current enrollments now warrant.

The effect is states are spending to treat the symptom, instead of addressing the cause of the problem by prompting districts to rethink their expenditure structure. But, in states, the extra funds included in these allocations for phantom students mean there are fewer funds for real students.

iii California's new finance formula known as Local Control Funding Formula is changing this relationship somewhat.

iv Margaret Weston, Funding California Schools: The Revenue Limit System, Public Policy Institute of California, March 2010.

v Total enrollment decline across districts between 2010 and 2011 is 89,234 students. (Authors' calculation using DataQuest). Note this is calculated on a per district basis – total enrollment decline from the California system as a whole was only 23,082. This implies a total of over 66,000 students taxpayers in California are paying for twice.

vi Colorado Department of Education (2011). Understanding Colorado School Finance and Categorical Program Funding. <http://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&ved=0CCwQFjAA&url=http%3A%2F%2Fwww.cde.state.co.us%2Fdefinefinance%2Fdownload%2Fpdf%2FFY2011-12Brochure.pdf&ei=VEg-UOCRfqpEpiAKizoGwDg&usq=AFQjCNHFgl0Sp2q1y75CHpPqoxHsozpPCA&sig2=3p-EoLRoqh1fMIXaUzNjsw>

vii Engdahl, Todd (2010). Intriguing findings in declining enrollment study. <http://www.indenvertimes.com/intriguing-findings-in-declining-enrollment-study/>

viii Pacey Economics Group. (2010). Findings and Highlights of the Declining Enrollment Study.

A secondary result is one that affects the behavior of districts. By continuing to fund phantom students in this way, he states' allocations work to ensure that the district expenditures don't get restructured appropriately for the smaller enrollments. Where the district has a large professional development department, or too many kindergarten teachers, those positions may stay on the district payrolls after the enrollment has started to dive. The extra state monies make it possible to do so.

As one study of declining enrollment districts found, while districts had real challenges reducing transportation costs, they do have more flexibility in adjusting expenditures on "other categories such as other supporting operations and maintenance, instructional salaries and benefits, food service, and administration."<sup>viii</sup> In other words, they can reduce costs when they have to.

## # 2 Hold-Harmless Provisions for Districts Competing with Charters

Buried deep in numerous state charter laws are promises to districts that they will be financially protected when students shift from their district schools over to charters. The promises are often the result of political negotiations done to secure sufficient votes for a charter policy. At the time of the writing of this paper, this issue was center stage in Washington state. A charter initiative was on the ballot and the opposition warned of impending financial pain to districts if charters are approved.

The promises made – called double-funding in some states – can take many forms, but they generally work much like the declining enrollment provisions. They slow drops in funding to districts when enrollment shifts to charters. The effect is the state funds students in charter schools in addition to maintaining district funding as district students leave.

In Connecticut, districts receive revenues based on the enrollments of students living in their region, regardless of whether those students attend the district schools or attend charters or technical schools. According to Hassel and Doyle (2010), the total double-funding bill in Connecticut for 2008 amounted to \$186 million per year in funding for phantom students.<sup>ix</sup>

In Massachusetts, charter school students take with them the per pupil net school spending from their sending districts.<sup>x</sup> To soften the blow to district finances, Massachusetts provides sending districts with a partial tuition reimbursement for up to six years after the student leaves the district. The first year after a student leaves for a charter, the state reimburses the district for 100% of lost tuition from the student, for the next five years the state reimburses the district 25% per year. Thus, the state essentially provides districts with 225% of a years' tuition for each student lost!

The results of such policies are the same as generic declining enrollment provisions, but with an additional consequence. For qualifying districts, the allocations could create a pernicious disincentive to improve services. For each student that leaves a district to attend a charter, the result is an *increase* in per student revenues for those remaining in the district.

Here again, while the root of the allocation was political promises to districts made to get charter legislation in place, the justification was that districts would be harmed by having to shrink. As the above section describes, rather than keep the funding in place at the district, another option would have been to prompt change in the manner in which districts structure their allocations. That way, they could more readily adapt to their shifting enrollment trends.

ix Hassel, Bryan and Doyle, Daniella (2010). The Tab. ConnCan.

x Net school spending is a combination of both district raised funds and state funding. The amount of net school spending and the relative levels of local versus state funds included in tuition to charter schools varies according to a complex funding formula that includes prior district spending, student mix, and tax base in each district.

### #3 Small District and Small School Subsidies

Small districts, it is thought, have no way to benefit from economies of scale and thus more funds are needed to provide a minimum level of services. The result is that smaller districts in most states receive more funds per pupil than their larger counterparts. According to a 2010 *Education Week* report, 29 states have an explicit “weight” in their state allocation formula to accommodate district size.<sup>xi</sup>

In Maine, for instance, the biggest districts spend, on average, \$8,033 per pupil compared to the \$11,027 for the smallest districts – a subsidy that implies the smallest districts have almost 40% more students than they actually have (Bowen 2007), amounting to a total of \$9 million in total subsidy for the smaller districts. In California, very small districts with fewer than 100 students receive, on average, more than \$18,000 per enrolled student, or more than twice as much as districts that enroll at least 1,000 students. And continuing the pattern, districts with fewer than 1,000 students receive more than their larger counterparts.<sup>xii</sup>

Here again, the small district subsidies work in different ways with some states making a small district subsidy allocation directly to smaller districts. In others, the state simply allocates some items (e.g. staff or programs) in “one per district” amounts such that when the costs of those items are divided by the lower enrollment of smaller districts, price tags are quite high.

It is often assumed that larger school districts provide economies of scale when compared to very small districts. However, the actual research on this topic suggests that the economies of scale assumed to exist for larger districts may not be realized and in fact, largeness may be a disadvantage for some of the largest districts.<sup>xiii</sup> (In addition, some studies question if larger districts actually suffer from diseconomies of scale that work against improved student outcomes).

But in any case, not all states have bought into the need for small district subsidies, providing some evidence that they may not be necessary for small district survival. As Figure 1 indicates, the extent to which small districts are receiving extra funds varies enormously by state among those states with small districts (here defined as having 200-1,200 students). Using adjusted spending by district (as reported by the Center for American Progress) we find that in some states, like California and Georgia, smaller districts receive 15% or more than the adjusted per pupil amounts of their larger district peers in their own states. Others, like those in Minnesota and Wisconsin, in contrast, have small districts that operate at levels on par with their larger peers.

Even if there are lost economies of scale, small district subsidies discourage merging districts or sharing services across districts – both a potential means for gaining economies of scale. Charter schools (essentially single school districts) have learned this lesson and often combine to share purchasing, specialized services, or back office functions. Even larger districts often share services across specific areas such as special education provision or vocational education.

xi Hightower, Mitani, and Swanson. (2010). State Policies that Pay. *Education Week*.

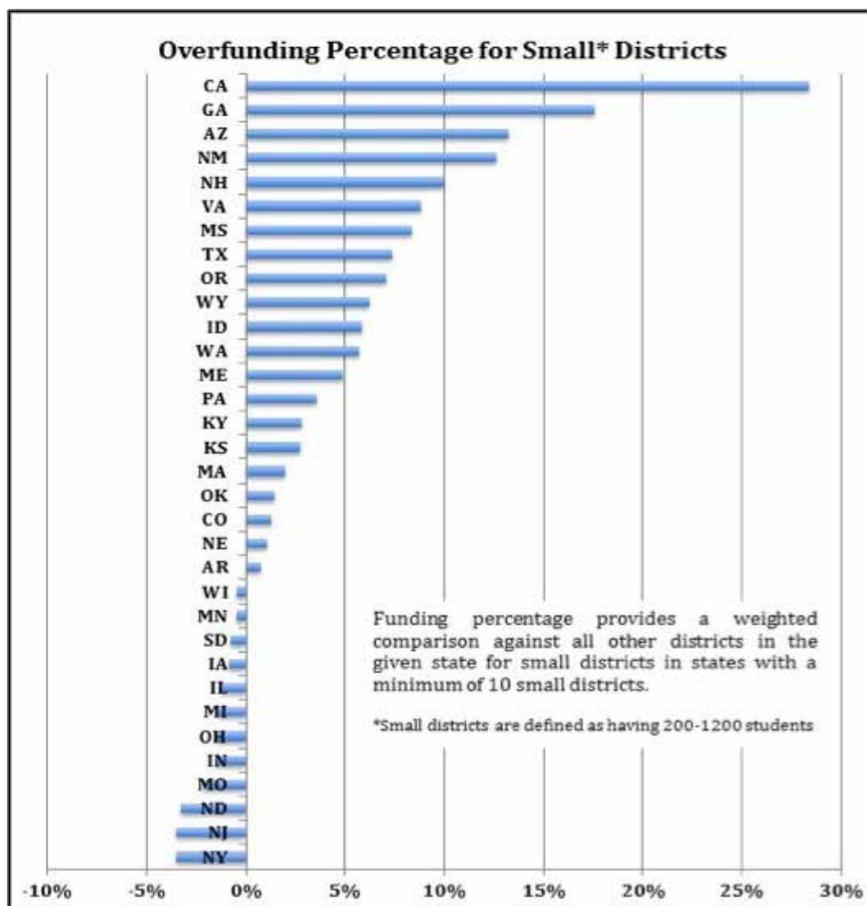
xii [http://www.lao.ca.gov/reports/2011/edu/district\\_consolidation/district\\_consolidation\\_050211.aspx](http://www.lao.ca.gov/reports/2011/edu/district_consolidation/district_consolidation_050211.aspx)

xiii Duncombe 2010, Cox & Cox 2010; Groan & Murray 2004; Streinfel, Foldesy, & Holman, 1991).

Finally, small district subsidies reinforce the assumption that there is one best method to deliver schooling – a traditional school building with a principal, nurse, on-site teachers in all subjects including specialty courses, etc. It is this mindset that has prompted small school groups (like the Rural School and Community Trust) to seek both small district subsidies and protections against loss of enrollment to charters on the grounds that a minimum amount of total dollars is needed to offer programs for students.<sup>xiv</sup>

As such, the pressure is removed for these districts to adopt new schooling models that might be better suited to serving students dispersed across a large area and provide them better access to teaching talent. As some small isolated districts have found, rapid advances in digital learning technology are able to provide students with better course options than they currently receive in isolated schools facing weak labor markets – all at a per pupil cost that provides parity with other districts.

Figure 18.I. Some States Vastly Over-Fund Small Districts Relative to the State Average While Others Don't.



xiv [http://www.ruraledu.org/articles.php?id=2926&utm\\_source=Rural+Trust+Constituent+List&utm\\_campaign=a7f4b4635d-RPM\\_July\\_20120801&utm\\_medium=email](http://www.ruraledu.org/articles.php?id=2926&utm_source=Rural+Trust+Constituent+List&utm_campaign=a7f4b4635d-RPM_July_20120801&utm_medium=email)

#### #4 Minimum Allotments for Categorical Allocations

A fourth type of phantom funding is created by the formula minimums of categorical allocations. In funding school districts, 49 states make at least some form of categorical allocation whereby some funds are targeted for specific student types, programs, or other purposes.<sup>xv</sup> Categorical allocations can include those for bilingual education, nutritional programs, drug awareness, dropout prevention, and the like.

In some cases, the targeted allocation distributes a fixed dollar amount for each relevant student (say, each bilingual education student) and then includes a minimum allocation for those districts with very low numbers of the targeted population. A district with only a handful of bilingual education students, for instance, would still be guaranteed a minimum dollar amount for bilingual education even when that fixed amount yields a vastly inflated spending level for each of the handful of bilingual education who attend the district.

Usually, whether apparent or not, the formula minimums have their origin in the politics of the legislative approval process. Those proposing legislation for categorical allocations know that before understanding the justification for some legislation, many legislators will quickly flip through the bill in order to see how much money is at stake for their district: the minimums are included to entice legislators to vote in approval knowing that the allocation brings home some cash to their community.

The result can mean the funding is deployed even to districts that don't have significant numbers of students who qualify for the funding. For example, previous work<sup>xvi</sup> by one of the authors found that Washington state's 2004 compensatory allocation formula made sure that even the more affluent Bellevue School District, which has only 18% of its students qualifying for Free or Reduced Lunch (FRL), receive some minimum level of compensatory funds. Those funds, when spread over Bellevue's meager poverty population, amount to an allocation of \$1,371 per poor student. Other large urban districts in the state received less than half of that for each of its impoverished students.

The justification follows a similar logic on the other phantom allocations and assumes that costs of any services for a particular student type require some minimum level of staffing dedicated to the effort. For the more affluent Bellevue School District, the result is extra state funding for the handful of qualifying poor students simply because the district has so few of them.

Figure 18.2. Categorical Minimums Yield Higher Per Student Funds in Districts with Extremely Low Numbers of Qualifying Students.



xv Hightower, Mitani, and Swanson. (2010). State Policies that Pay. Education Week.

xvi Roza, M and Guin, K. What is the sum of the parts. (2008). Center on Reinventing Public Education.

## WHY ARE PHANTOM STUDENTS A PROBLEM?

As noted above, for a myriad of reasons it actually is harder for districts to deal with shrinking revenues due to enrollment fluctuation than with increasing revenues. And for small districts or small programs, constructing non-standard program offerings that enable comparable per pupil costs takes some creativity to ensure that programs don't rely on typical full time staffing models. Declining enrollment, increasing competition, and subscale schools attempting to deliver education in the "traditional" manner force many districts to reduce services, cut "non-core" classes such as music and art, and potentially raise class size. Ultimately, if these districts do not restructure delivery and/or close schools, they could go bankrupt. Perhaps funding phantom students – funding districts according to how they once were rather than what they are now – is reasonable.

We see three primary arguments against the funding of phantom students.

First, the challenge that school districts face is not fundamentally different from the challenges other sectors face when operating on a smaller scale or when competitors "steal" their customers. Smaller outfits might get by because their staff can perform numerous functions, or they contract for some services that don't warrant full time employees. The same is true for other industries that lose revenue when customers leave. When a longtime Ford buyer switches to Toyota, it would be startling to suggest that either the buyer or the taxpayer provide Ford with makeup revenue to ease them through the transition. Yet this is what many states are doing with districts. Given that demand for one company's autos is likely to fluctuate, our expectation is that the company should be able to adapt accordingly. In school districts, where enrollment is inherently bumpy, funding for phantom students has eliminated much of the need to be able to adapt as student populations shift.

Second, funding phantom students delivers the message that how education has traditionally been delivered by school districts for the last century should be continued if at all possible. Phantom students and minimum allocations to pay for specific activities serve to prevent radical redesigns of how school is delivered. If, indeed, we have found the "one best system" this is all to the good. On the other hand, if we have not (which our relative international performance might suggest), or even if we are not sure, this system discourages experimentation.

Finally, and perhaps most importantly, funding phantom students diverts public funding from other uses. Proponents of protections from declining enrollment or small schools rightly note the challenges of downsizing. However, in deciding to protect declining enrollment districts, policy makers should also be considering alternative uses for that money – some of which might be directed to fund the most vulnerable students directly.

Clearly, the funds could be redistributed more evenly across all schools, or such funds might be used for growing early childhood services, or augmenting children's health care, or improving post-secondary options for disenfranchised students. The fundamental question is whether districts that are sub-scale or losing population be protected and even rewarded relative to other districts that do not find themselves in this situation.

## WHAT CAN STATES DO TO BETTER EQUIP DISTRICTS IF PHANTOM FUNDING IS ENDED?

Ending the funding of phantom students will not be easy – from either an organizational or political point of view. That said, there are numerous actions states can take to prepare districts and the public for thinking about schooling and education funding in new ways and to make a transition in a fair manner.

### Prompt Districts to Structure Allocations in per Student Terms

Rather than operate on the notion that there is a critical mass of students needed for fiscally viable district operation, or that the loss of funds due to declining enrollment must be offset with new funds, a better option is to address the source of the disruption—namely, the misalignment between what drives revenues and what drives expenditures. On the revenue side, most funds come in the door in ways that are tied to student counts. For San Francisco, a reduction in one student equates to a loss of \$5,000 in state money.

The expenditure side is a different story. A loss of one student doesn't automatically trigger *any* change in the budget, unless district leaders pull out a scalpel and start making bigger cuts. Districts have staffed their schools estimating how many classes they'll need, and made sure each school has a counselor, nurse, a parent coordinator, and so on. And then each central program (say, a program to create awareness about college), has an administrator at the helm, and some assigned number of FTEs. But then when a handful of students leave, these same line items cost more in per-pupil terms as the denominator (pupils) drops. Districts consolidate classes where they can, but then imagine that their only option to reduce costs is to pull some staff from the schools (ending the parent engagement program) and eliminate some of the central programs (like the college awareness effort). In other words, districts have constructed their budgets such that allocations aren't tied in any meaningful way to how many students there are.

If we accept the fact that fluctuations in enrollment are inevitable, one solution to the problem of financial strain with enrollment decline or sub-scale enrollments is to rethink the district's expenditure structure. Toward this end, districts should be creating more nimble fiscal systems, in which expenditures (like revenues) are tied directly to annual enrollment. For districts, this means reconfiguring budgets so that the allocations for schools or different services are structured on a per-student basis. Each school would receive a specified dollar amount for each student (or each student type) so that a school's allocation automatically rises and falls with enrollment. School districts like that in Houston, Denver, and Oakland already allocate funds to schools in this manner. Central programs too might be funded in the same way such that a program to create college awareness, for instance, might receive \$100 per eligible student each year, instead of an allocation of some fixed number of FTEs. This kind of expenditure structure is currently being implemented for central departments in Baltimore City Schools.

The idea here is that districts adopt student-based formulas to drive funds out to schools and departments. In this model, the total spending on district schools and services automatically drifts up and down with enrollment, thereby better matching the revenue trends. For each school, more incremental changes can be made on a yearly basis to reflect trends in the size of the student body. The more allocations that districts structure around enrollment (not only to schools, but also to departments, services, operations, administration, or other district functions), the more protected the district is from sudden deficits emerging due to shifts in the student population.

This kind of allocation model not only makes district-level budgeting much more responsive to changes in enrollment but also protects services from wholesale elimination with each budget cycle. For the example of the college awareness program in a declining enrollment district, services may need to be redefined when students counts drop – perhaps by rethinking delivery, or relying on a part time staff – but the program doesn’t go away. For each program or service, as enrollments decrease (or increase, for that matter), the per-pupil allocations stay the same. Where middle school science was a priority, it is still a priority. Where parent engagement was thought to be important, it still is, but the need may be met in a different manner than assigning a full time staff person to each school to lead the effort.

It is true that as districts shrink, some district services will miss out on economies of scale—at which point the department may need to deliver services in a new way, possibly by jointly providing the service with another district or contracting out for the service on a per-pupil basis. But rather than have the district leaders make those cuts from the top, adjusting to current enrollment becomes the responsibility of each school and program manager. They are best suited to figure out how to deliver their services on a year to year basis. And that’s where the adaptation and adoption of innovations can happen. Leaders of, say, a high cost speech therapy program, are driven to explore new methods of speech therapy, possibly considering any one of the new technologies that now permits remote speech therapy and decreased staffing costs.<sup>xvii</sup> In this mode of budget management, adaptation happens within the expertise of each department as it continually seeks to old per pupil costs steady amidst enrollment shifts.

### Restructure True Fixed Costs

As discussed above, in education, some costs are often assumed to be fixed that actually are not. While it certainly is easier to reduce a teaching position than to merge a school or restructure administrative operations and services, most operational and personnel costs of school districts are variable and could be structured to vary more directly with enrollment and revenues.

There is, however, a critical exception haunting many districts today. Lifetime health benefits and defined-benefit pensions, sometimes guaranteed decades ago, have created ongoing costs for districts that are unconnected to revenues and enrollment and cannot be easily reduced. As of 2009, the Los Angeles Unified School District, a shrinking district, had an unfunded actuarial accrued liability of \$10.3 billion for employees’ future post-employment health care costs. The size of this liability was more than 200% of the active payroll.

The net result of these promises to past teachers is that in 2011 the district paid \$240 million in health and medical benefits for retirees and their dependents.<sup>xviii</sup> Note that this cost relates only to the number of retirees, not the number of existing students or current employees serving these students. Thus, as the district shrinks, the per student cost of past promises will continue to increase, draining present day services for the ghosts of students and teacher past. Note also that charters and other competitors in the education space have none of these liabilities and are thus able to devote a greater portion of current revenues to current students. Not unlike the U.S. auto industry, many districts find themselves caught in historical cost promises unrelated to current operations.

<sup>xvii</sup> See for instance: How Online Speech Therapy is Transforming Speech Therapy in School Systems.

<sup>xviii</sup> Note that this represents current year expenses only and does not include any retirement of the liability. Los Angeles Unified School District, Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2011, p.50.

One answer to this challenge might simply be “Too bad!” Districts entered agreements to fund these benefits and did not set any money aside—they made their own bed. However, this is not quite fair. Those who entered the agreements generally entered them years ago, and the administrators, voters, and union leaders that allowed this are all long gone. Indeed, one wonders whether knowing that this payment on promises was going to be other people’s problem was something that made them easier to enter into. Today, however, payments are coming due.

One way out of this mess is for states to execute a grand bargain to fix this problem going forward. States could assume existing liabilities from school districts, effectively spreading the costs across all current providers. Simultaneously, though, states should adopt strict requirements that, from this point forward, districts (and other providers) must fully fund all employee benefits in the year that those benefits are accrued. While this clearly does reward the irresponsibility of past leaders, it is not the current students or school boards that created this mess. In order not to recreate the same problem, full-funding of future benefits offered by districts must be strictly enforced.

### Limit Districts’ Ability to Make Long-Term Commitments that Extend Beyond an Appropriate Funding Window

Following up on the above, states should regulate the ability of districts to make commitments they might not be able to pay for. Several states require districts to show that they will remain fiscally solvent for one or a few years and some require this as part of collective bargaining agreements. While this is a step in the right direction, districts are required only to show solvency under one set of reasonable assumptions. Instead, districts should be required to consider multiple scenarios and build into agreements revenue contingencies.

Defined-benefit and pension programs could be replaced with defined-contribution programs (a change already taking place in some locales). Tenure systems might be modified to allow for more fiscal flexibility, perhaps by including provisions for declining enrollment, or limiting the portion of the staff that can be tenured. However, it is unlikely that any of this can happen without states first providing the political cover for districts to do this.

And where state laws are the source of the problem, legislatures should work to change them. For instance, in some states, it is the state laws that are partially responsible for saddling districts with rigid tenure laws, seniority based layoff policies, or staff salaries that are forever guaranteed at the previous year’s levels.<sup>xix</sup> Initiating these changes in state and local policies can make it easier for districts to adapt from year to year.

<sup>xix</sup> New Jersey, for instance, requires that districts pay every teacher at least at the level of the previous year’s salary.

## Limit State Restrictions on How Certain Funds Can Be Used

As noted above, states often enact minimum distributions to districts that effectively assign some districts more of a targeted population than they actually have – creating phantom students. In addition, some state funding policies explicitly assume certain school structures: a specific number of students are expected to be in front of teachers within schools that have principals within districts that have a superintendent. As a result, small schools or districts *cannot* leverage distance learning or rearrange within school delivery to maximize student learning and minimize cost. The state essentially *requires* these schools and districts to have high cost structures. Thus, the state must make up for those phantom students that are not actually there.

## Create Demand for Ending the Funding of Phantom Students by Showing How Many Dollars in Per Pupil Terms are at Stake

As noted above, considered in isolation, it is indeed harder for districts (and every other institution) to face shrinking rather than growing revenues. However, the conversation around what else could be done with phantom student payments is often not pursued. States or independent research groups could open this conversation up simply by calculating the total amount spent on phantom students and the additional per pupil amount that would be available for *all actually living* students should phantom student funding be eliminated. While citizens and legislators may still decide that funding phantom students is a worthy use of resources, at least the tradeoffs will have been made clear.

The proposed changes to support more adaptive district budgets won't be easy, as traditional budgeting practices are deeply rooted in district habits and in local politics. School board members facing re-election may be encouraged to make promises that wreak fiscal havoc in years to come. But the benefits of moving to more nimble expenditure structures with multi-year budgets that plan for contingencies are real, not only in terms of long-term fiscal stability, but also in the sense that priorities can be articulated in district spending patterns. Under these conditions, district leaders will be quicker to seek out and adopt promising innovations that enable them to solve their cost challenges as scale changes. Perhaps most important, a more stable financial plan can set the stage for more stability in leadership, priorities, and strategies.

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