State Education Funding Shift Has a Disparate Impact on Minnesota Charter Schools

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A joint report by
Nonprofits Assistance Fund
Minnesota Association of Charter School
Charter School Partners

Executive Summary

The Nonprofit Assistance Fund, Minnesota Association of Charter Schools and Charter School partners conducted a survey of 110 of Minnesota's 149 charter schools (74% response) to understand how charter schools responded to the funding shift (holdback), including the availability of credit, the cost of borrowing, and impact on school operations and education services.

Highlights

- In the 2009-2010 school year, the funding shift, otherwise known as the 'holdback', increased from 10% of a schools budget to 27% (In 2010-2011 the funding shift was again increased to 30%).
- Charter schools have used every tool available to them to manage their cash flow, including internal fund balance reserves, renegotiating lease terms, budget cuts, loans from commercial banks, nonprofit loan funds, outside supporters and affiliates, and sale of receivables.
- Given that traditional school districts have taxing authority and a state guarantee of any loan, districts can typically receive loans with a 1% or less interest rate. Charter schools, who do not have these financing mechanism in place, have faced obstacles to accessing credit and must pay between 6% to as high as 23% in loan fees (includes interest, fees and legal expenses).
- A gross inequity exists between traditional school districts and charter schools as to how the holdback impacts their respected operations.
- A 30% holdback is unsustainable for many charter schools in Minnesota and unless this is addressed, solid, high-performing charters will be at risk of ongoing financial instability.

Recommendations to reduce the inequity

The report recommends three possible policy changes that could address the inequity and help resolve cash-flow gap financing issues for charter schools, including:

1) Reduce the holdback for charter schools from 30% to 15%.
2) Provide a state-backed, low-interest loan pool.
3) Improve access to private capital (market rate loans) via a state-authorized 'written assignment' to banks.

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Public school districts in Minnesota provide educational services to their communities with funds received from the state and from property taxes. The expense of K-12 education accounts for a significant share of the overall state operating budget. One of the strategies employed in addressing the state's budget deficits in recent years has been a shift in the timing of payments of state aid to public schools. All public school districts have been affected by the funding shifts. Due to a combination of legal structure, state restrictions, and financial scale, Minnesota's charter schools have borne a disproportionate financial burden as a result of the aid payment shift. This burden has had a direct impact in the classrooms and on the overall ability of charter schools to serve children in their communities. Every dollar paid for financing is a dollar that isn't available to pay for providing education to students. At a time when all public schools are expected to show results and help close the achievement gap, this burden is weakening some of the schools that were created for precisely that purpose. In February and March 2011, Nonprofits Assistance Fund, Charter School Partners, and Minnesota Association of Charter Schools conducted a survey to understand how charter schools responded to the funding shift, including the costs and impact on school operations and educational services. Survey responses were received from 110 of Minnesota's 149 charter schools (74% response).

Background

Minnesota was the first state in the nation to create charter schools in 1991. Nationally, there are now almost 5,000 charter schools and the federal government has recognized charters through a series of funding and policy initiatives. Today Minnesota has 149 operating charter schools, with two-thirds in the Twin Cities metro area, and half in Greater Minnesota. Together, these schools serve about 38,000 students.

Charter schools, both in Minnesota and other states, are true public schools. They are created by state law, are funded by government, and are subject to significant state laws governing public education. They cannot charge tuition and they cannot discriminate in admissions. They are subject to state graduation requirements and the mandates of the federal No Child Left Behind legislation. Teachers at charter schools are licensed by the state using the same standards as other public schools. Charter schools' primary source of revenue is the State of Minnesota, which provides funds to public schools throughout the state based on the number of students attending the school. Other sources of income include special education, compensatory aid, and lunch programs. State budget decisions affecting public schools apply to charter schools as well as traditional independent school districts. Structurally, charter schools are both nonprofit corporations and school districts. This structure presents complexities that affect many areas, including governance and financial management. While charter schools are recognized as public school districts, they do not have the taxing authority given to traditional independent school districts.

State Shifts Payments to Schools

State aid to public schools is paid beginning in July in even amounts over the year based on the number of students enrolled and attending school. The payment schedule includes a "holdback" amount to allow for final verification of enrollment and compliance with other requirements which is then paid to the schools in fall of the next school year. What had been a 10% holdback has been increased twice in the last two years to help address the state's budget problems. In the 2009-2010 school year 27% of state aid was deferred to the next year. For the current school year the shift is 30% of state aid. Because of the state's continuing budget difficulties, the payment shift seems likely to stay in place for years to come. This payment delay has resulted in cash flow challenges for all school districts, but the impact on charter schools has been more severe and much more difficult to manage. Charter schools took steps starting in 2009 to understand the impact of these changes by forecasting cash flow and employing appropriate strategies to use internal reserves and external financing.

Financing options for charter schools

Internal fund balance reserves: Schools with accumulated fund balances are turning to their own cash to cover as much of the cash flow gap as they could. Many schools, especially those open for only a few years, have very small reserves.

Renegotiating lease terms: The cost of school facilities is typically the second highest expense item, second only to salaries and benefits for teachers and other school staff. Some schools have been able to renegotiate the terms of lease payments to accommodate the holdback.

Budget cuts: Some schools have opted to close some, or all, of the gap with budget cuts. One reported that they cut teacher and staff pay by 20%.

Commercial banks: Schools are working with their current bank, or seeking interested banks, for lines of credit to bridge the timing of the state aid.

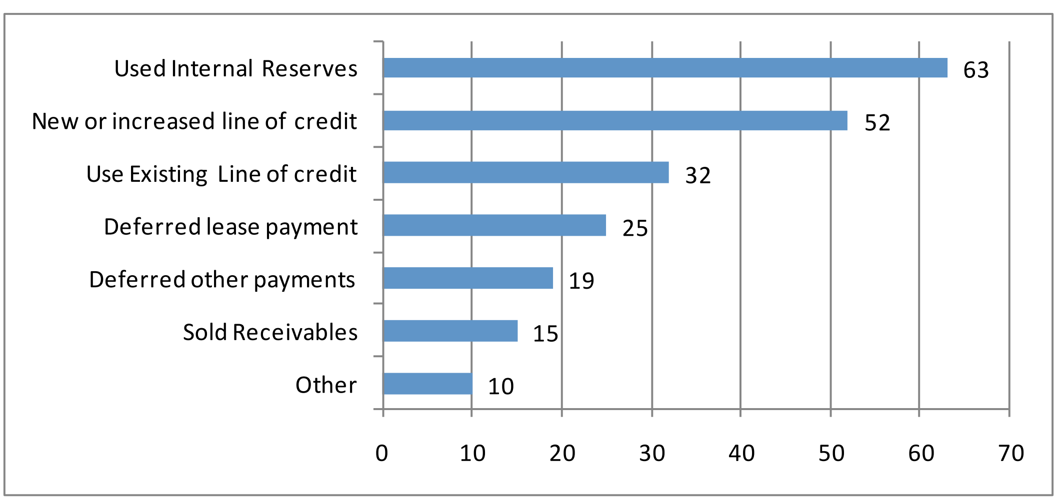
Nonprofit loan funds: Nonprofit organizations with a mission of providing financing for schools and other community organizations, including Nonprofits Assistance Fund, provide cash flow loans when the funds have sufficient capital.

Outside supporters and affiliates: A few schools with a parent organization, affiliate, or other well-established partnership have been able to obtain credit or cash flow assistance.

Sale of receivables: As a last resort, quite a few schools are selling their state aid payment receivable to a financing company on the west coast to obtain ready cash. These arrangements are much more expensive than bank loans and come with other conditions and controls that require close management attention.

Charter schools have used every tool available to them to manage their cash flow. Each strategy for managing cash flow requires different planning, information, and attention for school leaders and boards of directors. The survey explored the strategies used, costs, and impact on the schools for the school year that ended June 30, 2010, and plans for the current school year.

Of the 110 schools surveyed, only 13 were able to cover the entire funding shift with internal budget reserves. The rest turned to outside sources for deferred payments, loans, and other financing. Most schools reported that they used more than one strategy as shown on the chart below.



Disparate Impact on Charter Schools

Even with planning and careful budgeting, many charter schools encountered more barriers and costs than they anticipated. The shifts in state payments have affected charter schools more seriously than other school districts for a variety of reasons.

Limited reserves

School districts plan for occasional shortfalls and cash flow gaps by building reserve funds through their annual budget process. Over time, districts accumulate sufficient reserves to manage through economic downturns, including the current holdback. Charter schools are relatively young organizations. The oldest charter school in Minnesota opened in 1992 and many have been open less than 10 years. Most schools have not been able to accumulate sufficient reserve funds to cover a 30% cash flow delay. While all schools have used the reserve funds they have, most have needed to also tap other sources.

Access to Capital

The most serious problem faced by charter schools has been the difficulty of accessing credit to bridge the cash flow delay caused by the holdback. Even experienced finance directors and professional advisors from audit firms were surprised by the barriers that schools met when they applied for loans. Charter schools do not own many assets that are attractive to lenders. Commercial banks have been very hesitant to lend to charter schools because of limitations on using state aid payments as collateral and concerns that the state budget situation could get worse. Even for those schools that have been able to obtain a line of credit, the amount of time and management attention required was extraordinary. One school director summed it in one comment, "I want to add that finding a loan was much more difficult than financing the loan." The difficulty in obtaining market rate bank loans led many schools to make major budget reductions or to resort to selling their state receivables to a financing company.

"We approached 14 banks in the Twin Cities because our bank was not sure. Then finally they came through – if not we would not be here."

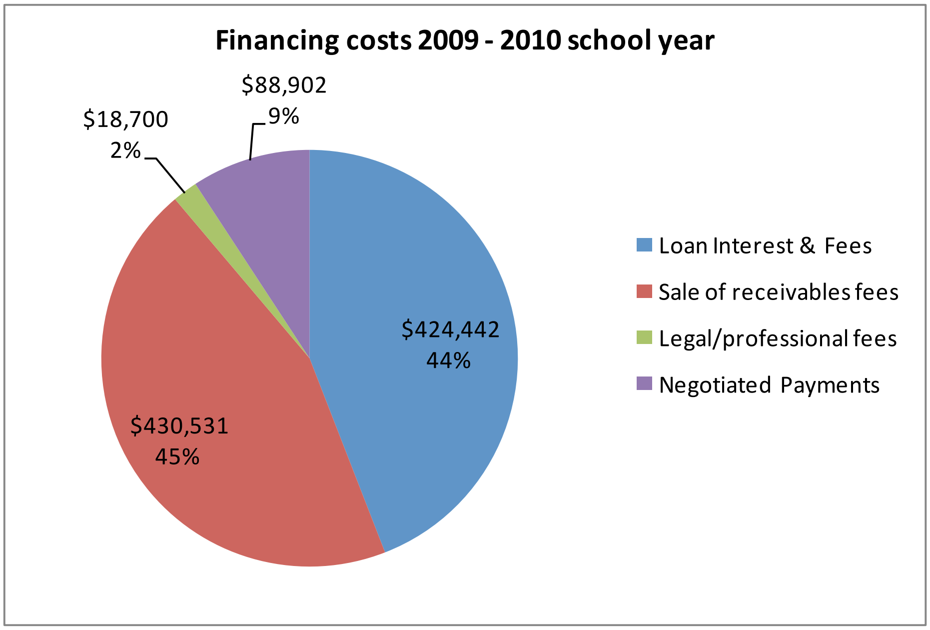
Cost of borrowing

The barriers to accessing credit are reflected in the costs of borrowing. Interest rates and related costs paid by schools, including fees and legal expenses, range from 6% for bank loans to as high as 23% for schools that sold receivables. Financing costs are paid from the school's operating budget and the increased financing costs required reductions elsewhere in schools' budgets. Surveyed schools reported cuts in music, foreign language, and enrichment programs. One school director wrote that salaries and benefits were cut and the cost of financing was one of the factors. The survey revealed that the direct cost of financing has been high for charter schools. For the 2009- 2010 school year, surveyed schools report total direct cost of financing of $962,575. This equates to an estimated average rate of 10% to borrow funds for cash flow. The costs include interest on loans from banks, fees paid for selling receivables, and costs for legal guidance and payments to landlords and vendors for deferred payments. In addition to these direct expenses,

If the state payment shift affects all public schools, what are the state's traditional independent school districts doing to manage their cash flow?

*Traditional public school districts have ready access to very low cost credit in the form of **Aid Anticipation Certificates**, a well established tool for public agencies to finance the cash flow of expected payments from the state. Aid anticipation certificates are available to independent school districts because of their status as a public agency with taxing authority. The school districts borrow these funds as general obligations of the district. In the remote case that the state does not pay the deferred aid payment, the school district could levy additional property taxes to pay the debt. As an additional protection, the state guarantees payment of the funds if the district defaults. The risk is minimal to investors, resulting in low rates, typically 1% or less. This form of borrowing has an active market and is available to every independent school district. Contrast this access to affordable credit to the time consuming process and rates of 6% to 23% paid by charter schools that lack taxing authority and the state guarantee.*

school directors, business managers, and board members had to divert many hours from focusing on students to contacting banks, negotiating with landlords, and chasing sources for short term borrowing. The chart below breaks down the expense by each type of financing costs.



An Ongoing Problem
The state aid payment delay is in place for at least two years and is highly likely to continue into the future. Borrowing from a line of credit or selling receivables addressed the problem for last year but each school now must repay those loans and make new plans for this year's cash flow. Surveyed schools reported that they would use a similar variety of reserves and financing tools this year. Interestingly, more schools reported that they will be seeking new or increased lines of credit. This is evidence that the banking marketplace has not completely met the need for financing. Since financing will be a regular practice for charter schools, schools now include financing costs in their budgets based on their actual costs last year. The 110 schools surveyed have budgeted $1,151,000 this year for financing costs. This is more than actual costs last year because of the snowball effect of the holdback, especially on schools that are growing and serving more students. Several components of state aid are based on enrollment during the previous year. Schools have made room in the budget for financing costs by reducing teachers, enrichment classes, technology, curriculum materials, and increasing class sizes. One director also noted that the payment delay resulted in a Catch-22 of sorts for their school – the school had difficulty meeting the state statute that requires payment of all bills within 35 days of when they are due.

"We are paying an effective rate of 23% on the funds we receive by selling our receivables, but the alternatives are not making payroll, or draconian cuts."

Addressing the Impact
Many education leaders in Minnesota believe that effective charter schools are an important strategy for improving educational results for students. The burden on charter schools of managing the cash flow of state aid payments is disproportionate to the size and scale of these schools. Instead of building a financial obstacle course for charter schools, the State of Minnesota needs to create ways to help charter school leaders so they can turn their attention and resources to educating kids. There are several approaches that could be used to address the problem, either individually or in combination.

Option 1: Reduce the holdback for charter schools
Recognizing the heavy burden that the payment delay has had on charter schools, the State could create a separate payment schedule for charter schools with a lower holdback percentage. Reducing the holdback to less than 15% for charter schools would allow more schools to manage within their budget reserves. As an alternative, a tiered holdback schedule could accommodate the schools that are most detrimentally affected based on enrollment, years in operation, and budget size.

Option 2: Provide cash flow gap financing
Finding credit has been the most difficult problem faced by charter schools. The state could provide an option for charter schools in lieu of Aid Anticipation Certificates by establishing a loan pool to bridge cash flow. Sources for funding a loan pool would need to be identified and a mechanism created.

Option 3: Improve access to private capital
One of the major factors restricting the availability of bank loans for charter schools is the lack of collateral. The state could assist charter schools in obtaining market rate loans from commercial banks by allowing state aid receivables to be pledged as collateral for bank loans and providing written assignment to the banks of the payments. The assignment would not necessarily equate to a guarantee in the event that a school does not meet state standards or does not comply with reporting requirements. Several banks have indicated that they would be open to additional lending to charter schools with written assignments. The state could also offer a guarantee of payment similar to the guarantee provided for other districts.

Summary
The shift in state education aid payments has had a detrimental effect on the stability and financial health of the state's charter schools. This disparate level of impact on charter schools is a result of a handful of state policies and structural requirements that require charter schools to operate within the budget and payment constraints that apply to public schools while at the same time preventing them from accessing the types of low cost credit that is available to independent school districts. As the State of Minnesota focuses on high quality education for all students, maintaining strong charter school options will be important. Until charter schools have access to appropriate, affordable capital to manage the cash flow burden caused by the holdback, their attention and resources will be divided between educating students and financing their budgets.

"The holdback is the biggest challenge our school has faced in 10 years."

Survey conducted by:
Nonprofits Assistance Fund provides loans for working capital and building projects with a focus on strengthening the operation and mission of nonprofits. We also offer financial management workshops and advice to strengthen nonprofit financial health and foster community vitality. Nonprofits Assistance Fund serves many charter schools with lines of credit to manage the state payment shift.
Contact: Kate Barr, 612-278-7182, kbarr@nonprofitsassistancefund.org

Charter School Partners is a nonprofit 501(c)(3) organization that supports high quality charters in Minnesota. We provide leadership capacity building support to existing charters that want to improve their academic and financial performance and we support the incubation of new charters that are specifically focused on closing the achievement gap.
Contact: Al Fan, 612-418-2935, afan@charterschoolpartners.org

Minnesota Association of Charter Schools (MACS) is a nonprofit membership organization advocating for the charter school community of Minnesota. MACS serves the charter school community as its voice in public policy issues, in facilitating innovation, quality and accountability, and facilitating networking and exchange services. MACS membership is open to charter schools, authorizers, other organizations and individuals.
Contact: Eugene Piccolo, 651-789-3090, eugene@mncharterschools.org