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SECTOR IN-DEPTH
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Public K-12 School Districts – US

Tightening operating environment will challenge a growing minority of districts

Summary

K-12 school districts benefited from an exceptionally favorable operating environment over the past few years, but conditions are shifting. A substantial infusion of federal pandemic-related aid for schools is ending. After years of expenditures coming in under budget as positions went unfilled, staffing costs are now accelerating and enrollment pressure is intensifying. Districts' ability to respond will depend in large part on their willingness and ability to wind down programs funded with federal aid, the flexibility provided by their state operating environment and if they were able add to reserves in recent years.

» **Extraordinary federal support is ending and state funding will not fill the gap.** School districts benefited from $190 billion in pandemic-related aid through the elementary and secondary school emergency relief (ESSER) program. But nothing of this magnitude is on the horizon to replace the lost aid at the federal level, and state funding is getting less generous. Districts that used ESSER funds on programs that officials perceive as crucial to maintaining student outcomes will face the most significant challenges.

» **Enrollment pressure due to demographics and competition is intensifying.** The primary demographic pressure on enrollment is falling birthrates and the resulting decline in the school-age population. Alternatives such as charter schools, home schooling and private schools are likely to continue drawing enrollment from public schools. Open enrollment policies meanwhile are increasing competition between districts.

» **Salary and benefit costs are rising after years of constrained growth.** K-12 salary and benefits costs are rising significantly because staffing levels are now above pre-pandemic levels for the first time and because districts have had to raise salaries.

» **State operating environments will be a key factor in districts' resilience.** For districts that rely heavily on state funding, operating in a state that provides for regular, predictable increases in funding will be key. For districts that rely primarily on local property taxes, the degree to which they can increase operating revenue within levy or millage rate limitations will be crucial. In some cases, voter support for property tax renewals or increases will also be an important factor, such as for Ohio school districts.

» **Median reserves are at a high point, but the trend of growing cash is not universal.** Districts that have amassed high levels of reserves have more runway to respond to the tightening operating environment. They can draw down some fund balance while maintaining their historical average and remain in compliance with fund balance policies. Credit pressure is likely to be most significant in states where school reserves are both lower than peers and lower than they were in 2019, as is the case in Washington state.

Extraordinary federal support is ending and state funding will not fill the gap

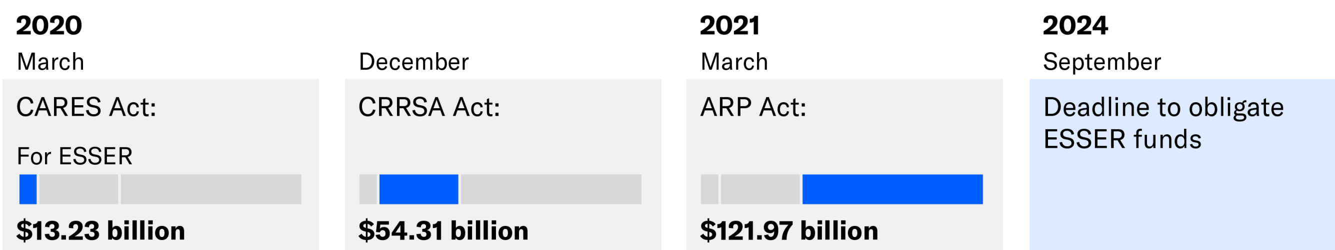
School districts benefited from extraordinary federal support over the past few years with $190 billion awarded in pandemic-related aid through the ESSER program. Many districts have already fully exhausted their allocations. For those with remaining balances, fiscal 2025 (which for most districts ends June 30, 2025) will be the last year that aid will be available. Moreover, nothing of the magnitude of the ESSER funding is on the horizon to replace the lost aid at the federal level, and state funding is unlikely to fill the gap. The districts that will face the greatest challenges as they deplete ESSER funds are those that invested in programming they regard as important to maintain in order to support student outcomes.

Funding was provided in three tranches (see Exhibit 1), with the largest ($122 billion) allocated through the American Rescue Plan Act (ARP) of 2021. That federal support is coming to end. The deadline to obligate funds is September 2024 for those with remaining balances. Districts then have 120 days to liquidate the funds.

Exhibit 1

Substantial federal aid was provided during the pandemic

Timeline of federal aid



CARES Act is the Coronavirus Aid, Relief, and Economic Security Act; CRRSA is the Coronavirus Response and Relief Supplemental Appropriations (CRRSA); ARP is the American Rescue Plan Act

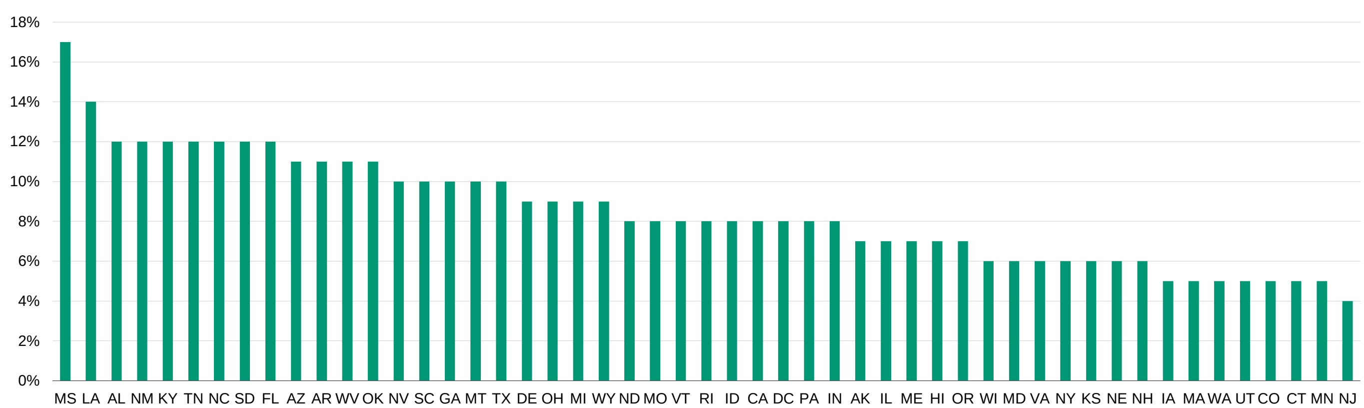
Source: Moody's Ratings

The infusion of federal aid was substantial. In all but a handful of states it amounted to over 5% of annual education revenue, and in many states it exceeded 10% (see Exhibit 2).

Exhibit 2

ESSER funding represented a significant source of educational revenue

ESSERs percentage of total education revenue by state



ESSER revenue is the one-year average allocated to each state across ESSER I, II, and III spread over three years

Source: Education Resources Strategies and Moody's Ratings

The awards provided varied greatly not just by state, but also by district because funds were awarded based on their historical receipt of Title 1, Part A federal aid. So districts with the greatest need received the largest allotments and will also face the greatest funding gaps as funding runs out.

State funding is unlikely to fill in the gap. Few, if any, states are proposing large reductions in funding. But funding in some states is getting less generous and in most instances will not be sufficient to bridge any shortfall for schools dependent on ESSER. For example:

» **California:** The state's initial budget proposed reductions for TK-12 education (transitional kindergarten through 12th grade). It appears now that the sector will be spared major cuts, but on a per-pupil basis funding will remain relatively flat from 2024 with just a 1% cost of living adjustment (COLA).

» **Texas:** The state's per pupil funding will remain flat in fiscal 2024 and 2025 for the fourth and fifth years in a row. Positively, population growth and economic expansion continues almost unabated in many districts, driving increased revenue.

» **Michigan:** The state held per-pupil funding flat in its fiscal 2025 budget. To provide districts with additional resources, the state reduced required retirement benefit contributions by school districts. However, less money today into the Michigan Public School Employees' Retirement System (MPSERS) means slower asset accumulation and likely higher long-term liabilities in the future.

Services often develop strong political and popular support, creating pressure to continue them when federal aid dries up

Some of the K-12 programming funded with ESSER dollars will be particularly difficult to cut compared with other items that cities and counties funded with federal aid. For example, many cities and counties allocated federal aid to offset temporary reductions in economically sensitive revenue like sales taxes, hotel/motel taxes and amusement taxes. Some of the programmatic investments by cities and counties were also relatively painless to roll back. Compensating hard-hit industries, utility bill forgiveness and providing home renovation grants, for instance, are programs that can be treated as temporary assistance. In contrast, in states reporting data, nearly 50% of ESSER III funding provided to schools was allocated to labor costs, including hiring teachers and support staff, lengthening the school day, and even providing salary increases. [1]

School district spending may gain significant political and popular support that makes it politically difficult to eliminate. When choosing how to allocate ESSER dollars, officials had to balance spending on programs that were most likely to improve student outcomes with spending on items that would be less likely to create a future structural budgetary imbalance. If the programs that were added or expanded strengthened student outcomes – or were simply perceived as doing so – they will be particularly difficult to cut. Districts that cut programs too quickly risk exacerbating social risks related to education, and become less competitive in attracting students, weakening enrollment.

Many, if not most, districts either allocated federal aid to nonrecurring expenditures such as facilities or spent funds on programs that are being phased out without difficulty. Some districts allocated ESSER funds to expenditure that they would have otherwise financed with local resources and therefore the aid indirectly added to reserves.

Enrollment declines due to demographics and increased competition are intensifying

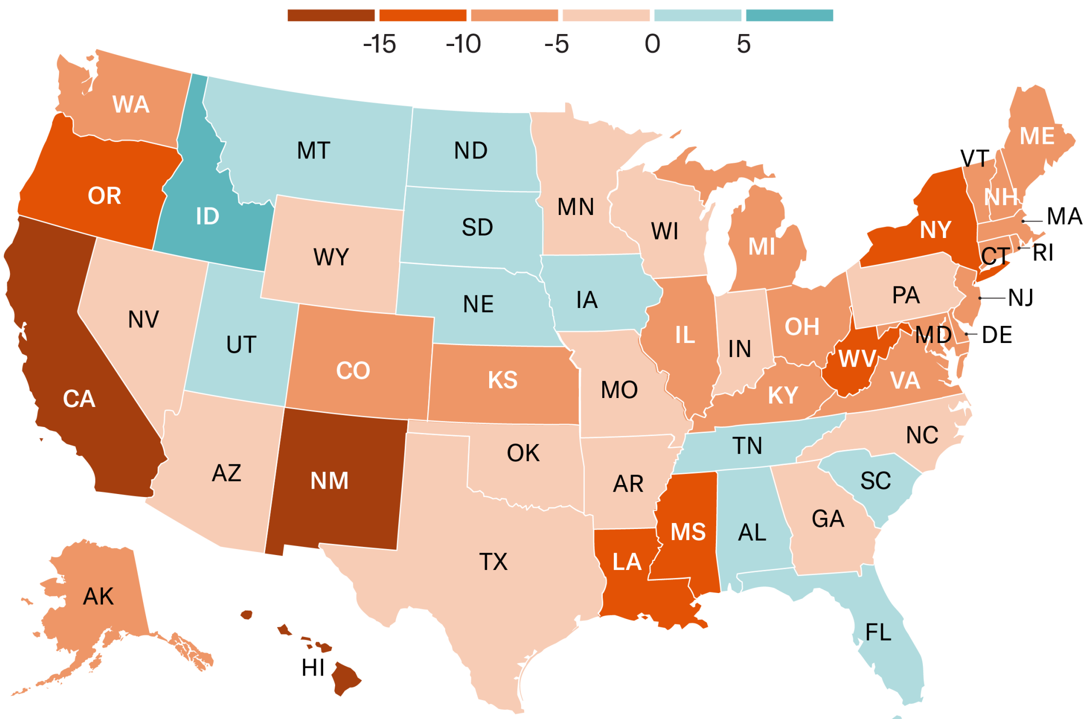
While the trend of enrollment declines is long-standing in most of the country, it is intensifying. Pressure on enrollment has two primary sources: demographic trends and increasing competition. The primary demographic pressure on enrollment is falling birthrates and the resulting decline in the school-age population. Legislation expanding school choice is gaining traction nationwide. Alternatives such as charter schools, home schooling and private schools are likely to continue drawing away enrollment from public schools. Also, open enrollment policies are increasing competition between districts. In many states, enrollment losses leads to declining revenue.

According to the National Center of Education Statistics, K-12 enrollment is projected to decline by 5.5% in the 10 years through 2031, including charter school enrollment. The declines will not be even across states (see Exhibit 3). Domestic migration patterns can exacerbate demographic challenges, in particular the trend toward movement to a relatively small number of urban and exurban areas. International migration could become an increasingly important factor as the US population ages, mortality rates rises and US birthrates fall.

Exhibit 3

Enrollment declines vary across the US

Percentage change in total enrollment by state projected from 2021 through 2031



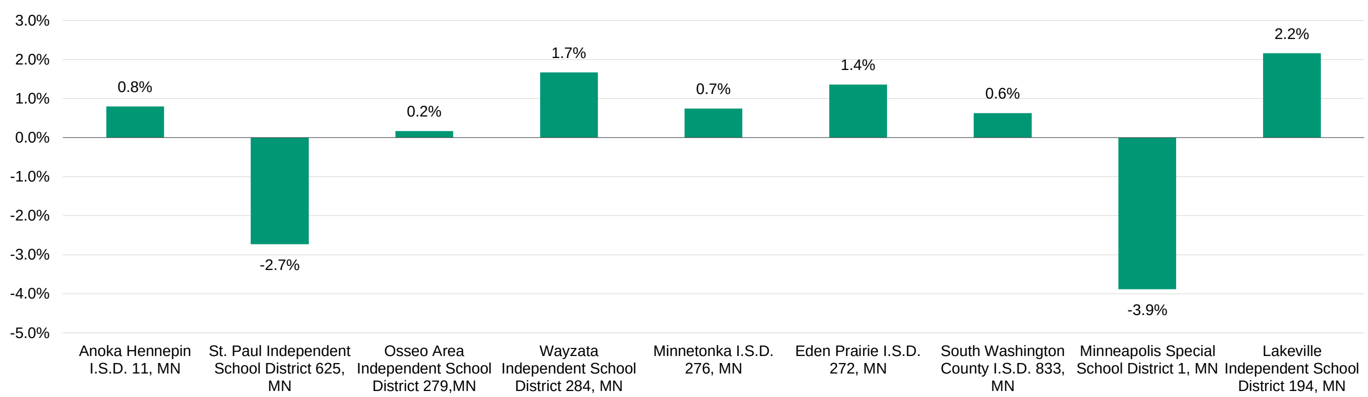
Source: US Department of Education and National Center for Education Statistics

Enrollment changes will be highly uneven across districts. Some districts will maintain positive enrollment trends even if located in states or metropolitan areas where the trend is negative and vice versa. For example, a sample of several districts in the Twin Cities metropolitan area shows significant variation in enrollment (see Exhibit 4).

Exhibit 4

Enrollment varies significantly within the Twin Cities metropolitan area

Enrollment trend (three-year CAGR in enrollment)



Source: Moody's Ratings

Competition in the public school sector takes three basic forms:

- **Charter schools:** Publicly funded schools that operate independent of public school districts. Charter schools are primarily funded from the same state per pupil funding as public school districts. Charter schools continue to proliferate and increase enrollment, which diverts students from public schools.
- **Open enrollment programs:** Some states allow students to attend districts other than the one they live in. The state aid often travels with the student. Historically, districts had to primarily contend with competition from a limited number of neighboring districts that were logistically convenient for parents. However, virtual academies spread substantially during the pandemic era.
- **Private schools and homeschooling:** While private schools have long been a fixture of the US education landscape, in recent years an increasing number of laws has allowed the use of tax dollars to fund private schools, including tax credit programs. The percentage of parents opting to homeschool their children, while still small, has been increasing.

Competition can add to credit risk in a variety of ways

First, competition can add a layer of unpredictability to financial planning. If demographic trends are the only variable, predicting enrollment is often fairly straightforward for management. Increased competition, however, makes it harder for district managers to project student counts for budgeting because it is difficult to predict how many students will choose other options.

Second, greater competition can prompt school districts to increase spending in an effort to attract students. For example, districts may opt for more expensive facilities than they otherwise would, or it may lead them to expand sports, extracurricular or educational offerings. While existing students may benefit from these investments, such expenditures are far from guaranteed to be effective in attracting new ones.

Lastly, if districts respond to declining enrollment primarily by reducing expenditures alone, it can create its own perils, especially if a "downward spiral" emerges. When a district cuts expenditures to cope with declining enrollment, that reduction can weaken a district's effectiveness and educational outcomes, prompting even more students leave the district. The loss of those students results in additional revenue losses, prompting further cuts, and so on.

Salary and benefit costs are rising after years of constrained growth

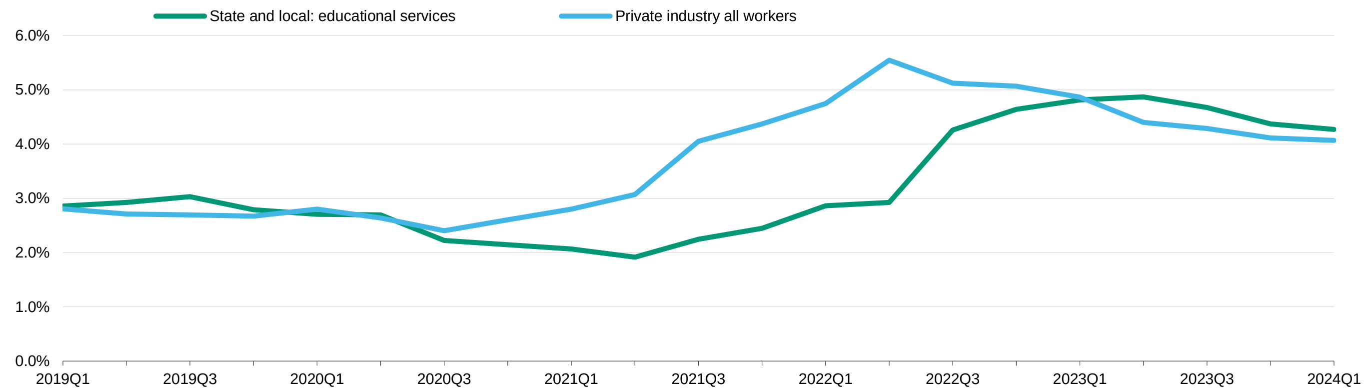
K-12 salary and benefits costs are rising significantly because staffing is now above pre-pandemic levels for the first time and districts have had to raise salaries. Both developments represent a reversal from the trend that held for most of the last few years, when districts were struggling to fill positions and compensation growth was constrained, leading to strong financial results. The reversal is causing districts for the first time in years to grapple with significant upward expense pressure from employee salaries and wages.

The cost of employing K-12 teachers and other staff is now growing slightly faster than the private sector (see Exhibit 5). During most of the recent inflationary period, K-12 employment cost growth trailed the private sector. District compensation growth was moderate in part because many districts signed multiyear contracts with union groups before the surge in inflation.

Exhibit 5

Compensation growth in the education sector has caught up with the private sector

Employment Cost Index (ECI) in state and local educational services versus the private sector



Includes wages, salaries, and employer costs for employee benefits

Sources: US Bureau of Labor Statistics (BLS): Employment Cost Index (ECI), and Moody's Ratings

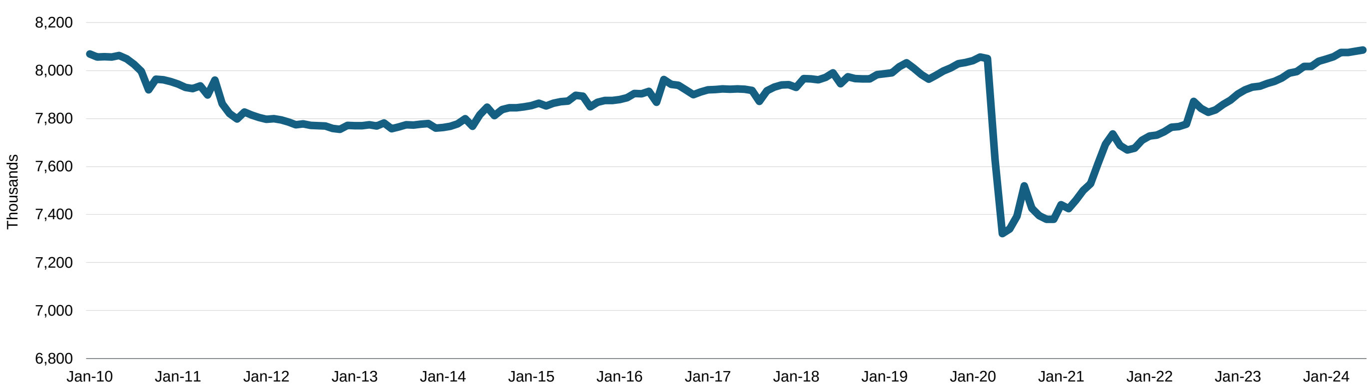
Apart from the union negotiations, the practical imperative to retain and attract workers was another driver of salary growth. Employment in the education sector recovered more slowly than the private sector after the pandemic with many schools experiencing substantial attrition and resignations. In addition to salary competitiveness, other factors made hiring tough, such as the difficult working conditions during the pandemic and the lack of a remote work option for most employees.

The efforts to improve compensation and attract employees has worked, with public education employment exceeding pre-pandemic levels for the first time in June (see Exhibit 6). The challenges of attracting staff differs by position, with special education openings and bus drivers being especially hard to fill, and by geography, with rural and large city schools often having the most difficulty filling positions. While some of those challenges may linger for some districts, overall staffing has recovered. In addition to backfilling positions for staff that departed during the pandemic, districts have also added staff funded with federal aid to address learning loss, such as counselors, social workers, tutors and reading and math specialists.

Exhibit 6

Public education employment levels now exceed pre-pandemic levels

Employees in local government education seasonally adjusted



Sources: Federal Reserve Bank of St. Louis and Moody's Ratings

State operating environments will be a key variable in districts' resilience

Districts' ability to respond to the tightening operating environment will depend, in part, on how they generate revenue. For districts that rely on state aid, operating in a state that provides for regular, predictable increases in aid will be an important factor. For districts that rely primarily on local property taxes, the degree to which they can increase revenue within levy or millage rate limitations will be key. In some cases, voter support for property tax renewals or increases will be an important variable.

State aid formulas are highly disparate. Several states have long held "hold harmless" provisions as a feature of their public K-12 funding formulas. Such provisions spread during the pandemic, but in some states were implemented only temporarily. Around half of the states have provisions that prevent or limit revenue declines from enrollment losses (see Exhibit 7). Districts in states with long-standing hold harmless provisions will be least affected by declining enrollment, while districts with pandemic-specific provisions will see the greatest impact.

Exhibit 7

Many states have provisions that prevent or limit revenue declines in K-12 revenue

Types of funding protections by state from strongest (left) to weakest (right)

Long-standing hold-harmless	Rolling mitigant	Loss cap	Pandemic-specific
Illinois	Alaska	Idaho	Arizona
Iowa	Arkansas	Nevada	Cailfornia
Massachusetts	Kansas	New Jersey	Florida
Nebraska	Maine		Michigan
New York	Maryland		North Carolina
North Dakota	Missouri		Texas
Ohio	Montana		
Pennsylvania	Oklahoma		
	Oregon		
	South Dakota		
	Utah		
	Wisconsin		
	Wyoming		

Sources: Edunomics Lab at Georgetown University and Moody's Ratings

For districts that depend primarily on property taxes for revenue, a number of variables come into play. Most such districts are subject to a cap on property taxes, which can make it more difficult to keep up with rising expenses. However, the nature of these caps varies greatly between states. Wisconsin had a particularly strict per-pupil revenue limit, holding it flat in six of the last 10 years before raising it by $325 per year in the most recent biennium budget. The state provided additional per-pupil aid outside of the revenue limit to partially mitigate the impact of the strict caps. In contrast, Illinois districts located in tax cap counties are able to achieve relatively solid compounding growth within caps that limit levy growth to the lesser of the consumers price index (CPI) or 5%, plus a number of exceptions including valuation from new property.

The ability to go to voters for increases in tax revenue, or the need to go to voters to maintain current revenue, is another variable for tax-dependent school districts. The revenue flexibility of school districts in Michigan, for example, is constrained because they cannot go to voters for additional operating levies. Their only options are to request capital levies or to request additional operating levies through intermediate school districts (ISDs)[2] – often difficult because it requires the cooperation of many districts. This limited flexibility was a key factor in widespread credit challenges in the last decade. More recently, the credit quality of Michigan school districts has largely strengthened as the state's per-pupil funding increased substantially and caught up to inflation.

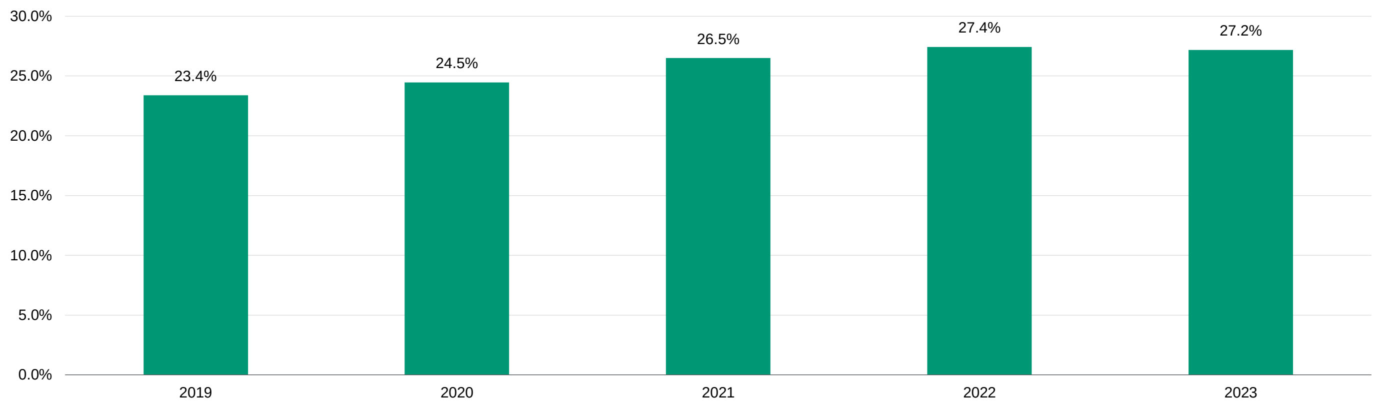
In some states voter, support is required just to maintain revenue. For example, Ohio school districts need to regularly seek voter approval because many of their levies either expire or do not grow with inflation. Many districts in the state see large fluctuations in reserves because of this levy cycle, and the ability to garner voter support becomes a key factor in credit quality. The approval rate for school district seeking authorization for new levies fell this spring to 17% from 33% the prior year[3]. Declining local support for levies has also been in a challenge in Washington state, where supplemental levy requests have been failing with more frequency since 2019.

Median reserves are at a peak, but the trend of growing cash is not universal

Median reserves across the sector are materially higher than before the pandemic. Districts that have amassed higher-than-historical reserves have more runway to respond to a tightening operating environment: they can draw down some fund balance while maintaining their historical average and remaining in compliance with fund balance policies. While the trend has been toward higher cash levels, however, some districts' reserves have stagnated or even begun to erode.

The large increase in reserves is due to the extremely favorable operating environment for schools in the past few years. Available operating funds peaked in fiscal 2022 and were flat in fiscal 2023 (see Exhibit 8). As fiscal 2024 audits come in, they are likely to indicate a flat-to-slight decline in median reserves. In fiscal 2025, median fund balances are likely to weaken though they will remain above pre-pandemic levels.

Exhibit 8
Median reserves are at a peak
Available operating fund balance as a percentage of revenue



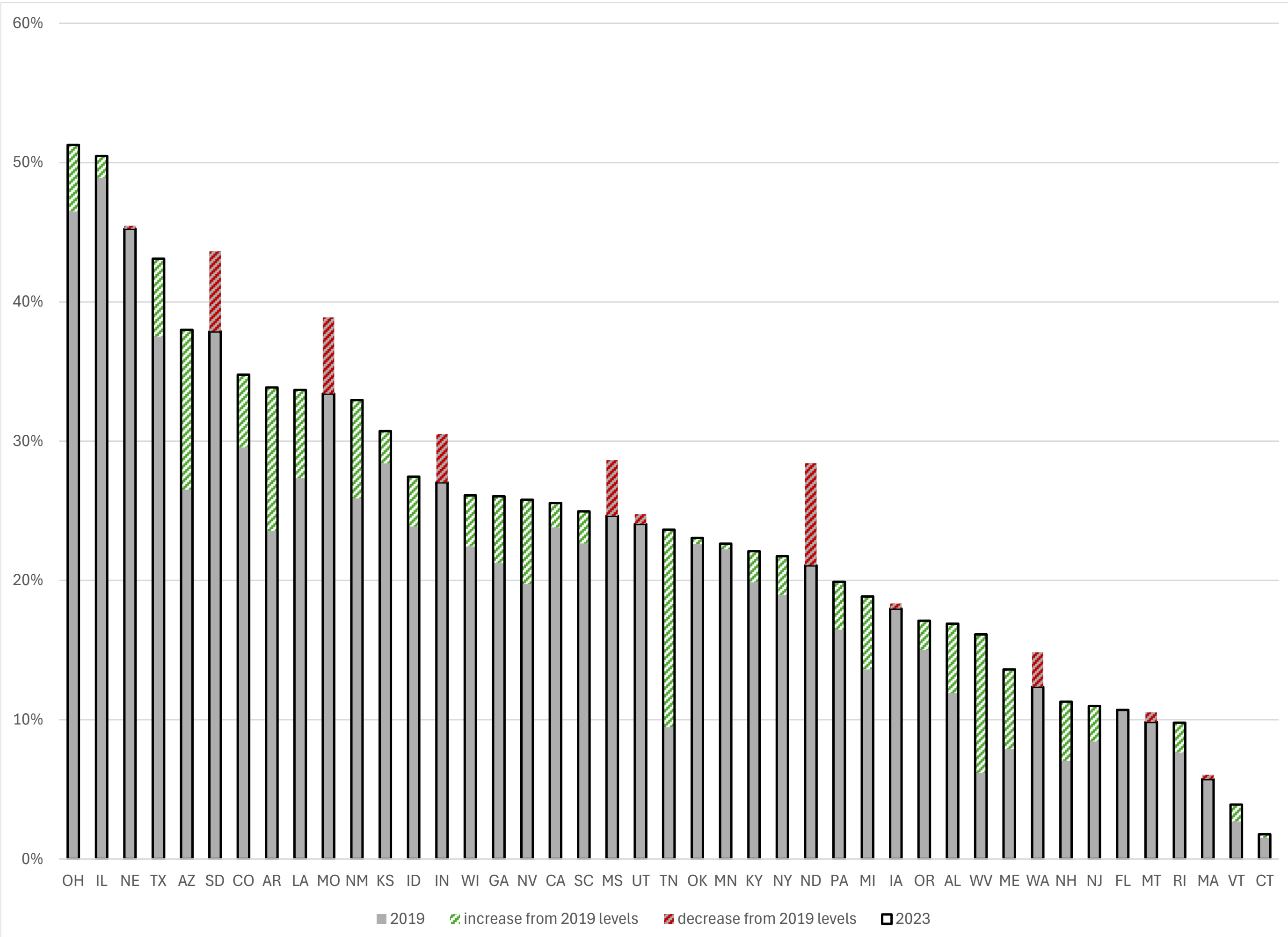
Source: Moody's Ratings

While the overall trend of reserve growth has been strong, it is not even across the sector (see Exhibit 9). Seven states have school districts with median reserves that are lower today than before the pandemic, and many states where median reserves are very similar to 2019 levels. Credit pressure is likely to be most significant in states where school reserves are both lower than peers and lower than they were in 2019, as is the case in Washington state.

Exhibit 9

Growth in fund balance is uneven across states

Median fund balance fiscal 2019 to 2023: red indicates decline and green growth relative to 2019



Source: Moody's Ratings

Northeast states tend to hold low reserves in part because many of the states have statutory limitations on the amount of fund balance a district can maintain. A number of factors can mitigate the credit impact. For example, regional schools have connections to member communities and can rely on the member town's financial strength as a buffer. Connecticut schools have strong revenue-raising flexibility to adjust rates and often very strong property tax bases.

Endnotes

1 Center for Budget and Policy Priorities, "Expiration of Federal K-12 Emergency Funds Could Pose Challenges for States."

2 ISDs are regional entities that provide services and support to school districts. Usually they extend countywide.

3 Ohio Association of School Boards

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