

Shaker Heights City School District

Citizens' Finance Review Committee Report

November 1999

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Citizens' Finance Review Committee Members:

Dean Kim Cameron
Mr. Robert Forward
Mr. Yank Heisler

Dr. Pauline Degenfelder
Mr. Reuben Harris
Mr. Pat Prout

Mr. Edward Hemmelgarn, Chair

The system for funding public schools in Ohio today places an immense burden on the local property taxpayer. The Shaker Heights City School District, like most districts in the State of Ohio, is therefore required as a result of the impact of the 1976 anti-inflation legislation, House Bill 920 (which has the effect of preventing any increase in tax revenues due to inflationary changes in property values), to return to the voters every three to five years. Such added revenue amounts are necessary to offset the increases to the District's expenditure base caused by a combination of contractual, inflationary, and statutorily mandated requirements. The alternative to raising additional local revenue is, of course, to reduce expenditures that have initiated and sustained the level of outstanding educational programming that has historically been provided by the Shaker Schools.

One does not have to look far to obtain objective evidence of the quality of the Shaker Schools:

- The graduation rate for Shaker Heights High School is 96.8%;*
- Shaker Heights seniors exceed State standards on all portions of the 12th grade proficiency tests;*
- In excess of 90% of Shaker graduates enroll in colleges and universities across the country; and*
- Each year, approximately 15% of the Senior Class are recognized as either National Merit, National Achievement, or National Hispanic scholars, compared with only 2% of high school seniors nationally who earn such honors.*

The Citizens' Finance Review Committee has unanimously and emphatically concluded that the District should place an operating levy on the March 2000 ballot so as to sustain the high level of educational service currently being provided. The following report details the process, background information, and the Committee's conclusions pertaining to this important issue.

Ohio public schools educate more than 1.8 million children in 611 public school districts, 49 joint vocational school districts and 64 educational service centers. An additional 200,000 children are educated in private schools or through home schooling. Ohio's school funding system is based on a theory of "shared responsibility," which calls for both the state and the local community to bear a proportional responsibility for making certain every student has the opportunity to receive an adequate education.

The task of assuring that its schools have necessary financial resources is one of a local board of education's most important responsibilities. To meet this responsibility, the Shaker Heights Board of Education conducts a continuous assessment of both current revenues and expenditures and projections for the future. In October, the District convened a Citizens' Finance Review Committee consisting of District residents to help assess the Schools' financial requirements. Two of the seven committee members also served on the 1992 and 1994 Committees. This past experience has enabled the Committee to observe and confirm consistent performance and reasonable trend identifications.

The Citizens' Finance Review Committee consists of the following individuals: Chairman-Mr. Edward Hemmelgarn, Shaker Investments; Dean Kim Cameron, CWRU, Weatherhead School of Management; Dr. Pauline Degenfelder, The MetroHealth System; Mr. Robert Forward, Brown-Forward Funeral Home; Mr. Reuben Harris, State Farm Insurance Co.; Mr. Yank Heisler, Key Capital Partners; and Mr. Pat Prout, Heidrick & Struggles (see appendix for brief bios on the committee members). The Committee was charged with the following tasks:

- Review the forecast assumptions made by the District Treasurer;
- Study the financial projections;
- If necessary, examine related documents concerning the District's finances;
- Conclude as to the financial necessity of placing an operating levy on the March 2000 ballot.

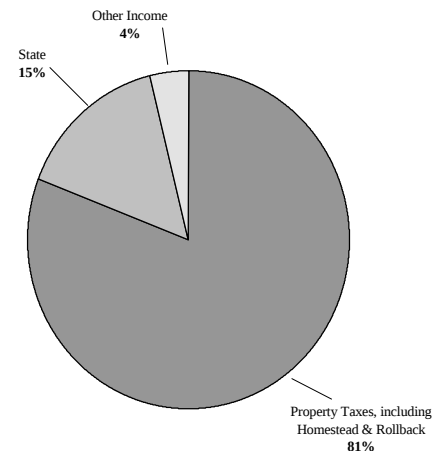
Consistent with its charge, the Committee met in October to review District financial information in order to form an opinion as to the necessity of an additional operating levy to maintain the current level of educational services. The Committee studied the financial projections and reviewed related financial information. It is to be noted that the Committee did not evaluate the quality of, or the need for, the current level of educational services provided by the District. The Committee members were provided with significant amounts of data to assist them in their mission. In order to ascertain whether new revenues are required, the Committee first gained an understanding of the various sources and uses of District resources, and the basics of school finance in the State of Ohio. The following list documents significant observations noted by the Committee with respect to school finance and funding in Ohio, and more specifically as they relate to Shaker Heights.

REVENUES

The two main sources of revenues for school districts in Ohio are local property taxes and State support through the State Foundation program. The District's revenues for fiscal 1999-2000 include approximately \$46.5 million from property taxes (including the state reimbursement for Homestead and Rollback payments) which represent 81% of the District's General Fund revenues. In contrast, the State contribution approximates only \$8.8 million, or 15% of total General Fund revenues.

Of the District's property tax revenues, approximately 76% or \$35 million are derived from the taxation of residential real estate (as opposed to the taxation of either commercial real estate or commercial personal property). This heavy weighting is of course due to the high percentage of residential property vs. commercial property that exists within the District boundaries.

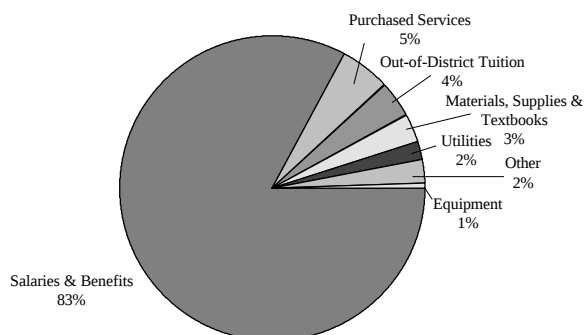
GENERAL FUND INCOME 1999-2000



EXPENSES

All school districts are highly personnel-intensive with respect to their ongoing operations. Historically, in Ohio 80% to 85% of school district budgets consist of salaries and wages and related employee benefits. For the fiscal year ending June 30, 2000, salaries and benefits make up approximately 83% of total expenses in the Shaker Heights District.

GENERAL FUND EXPENSES 1999-2000



The negotiated collective bargaining agreements determine salary and related fringe benefit payments for essentially all District employees. Additionally, Federal and State regulations require certain mandated services, e.g. special education, which have become significant cost factors for the District. The two major fringe benefit costs include the state-mandated 14% of salaries for retirement contributions, and health insurance which tends to experience a much greater inflation rate

than any other generally recognized inflation index. The Medicaid/Medicare tax expense for the District, while only 1.45% of salaries, is ever increasing as it is required by federal legislation to be paid for all new employees hired after March 1986. Consequently, such expense continues to increase as a percentage of the total budget every year.

Out-of-District tuition costs continue to soar due to the change in the State's funding formula for special education students. Not only does the cost of delivering such services continue to outpace

the general inflation rate, but the occurrence rate of special education needs is clearly on the rise both locally and nationally. Other state and federal mandates, including those enacted in the past, the present, and the future, continue to place additional time and financial burdens on the District.

SCHOOL FINANCE IN OHIO

On a big picture level, the State's approach to school financing is relatively simple. Unfortunately, because of social, fiscal and political realities, the simple approach is adjusted by various factors in a manner that complicates the system to the point that it is virtually incomprehensible to the average voter. The overriding premise of the State's system is the concept of "shared responsibility." The State formula for determining the proportion of shared responsibility consists of three factors: 1) the number of students in the District, 2) the State-determined total cost amount required to provide an "adequate" education, and 3) the sharing ratio of such cost to be borne by the local community.

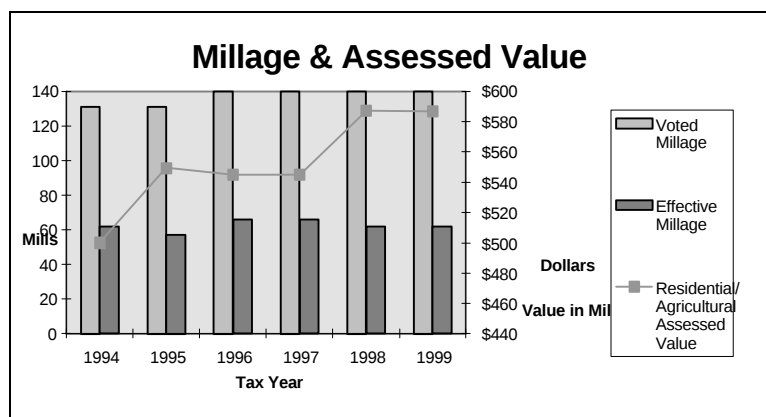
The number of students is determined according to rules promulgated by the State, and is calculated by virtue of a massive counting process carried out during the first full week of October, known as ADM (average daily membership) week. The State-determined "adequate" education cost for fiscal 2000 is \$4,052 per pupil, while the State-sharing ratio is determined by subtracting the equivalent of 23 mills of local property taxation from the product of the cost amount and the ADM number for the District.

This "shared responsibility" formula, however, results in substantial differences in funding levels throughout the State. Because of this reliance on the property tax base in determining the State share, Shaker Heights receives a relatively low percentage (36% in fiscal 1999-2000) of State support in the funding formula. The percentage of support from the state is even lower considering the District spends twice the amount per pupil that the State deems as the "adequate" cost amount. Consequently, the District must produce enough local revenue in the form of property taxes in order to completely fund its educational program.

HOUSE BILL 920

As an integral part of State law associated with the taxation of real estate, real property is re-appraised every six years, with an update in the intervening third year, by the County Auditor. Prior to 1976, the amount of tax levied would increase as the assessed (or taxable) value of real property rose due to inflation every three years. Because of the high inflation rate during the 1970's, property taxes rose in accordance

with the higher assessed values attributable to the reappraisals. In response, House Bill 920 was passed by the Ohio Legislature and became law in 1976, thereby implementing an anti-inflation device against what seemed to be a never-ending rise in property taxes. As a result, real property tax levies are now forbidden by law from generating additional tax revenues above the amount generated in the original year of approval, if such increase is solely attributable to the inflationary



increases caused by the triennial reappraisal/update process (i.e., new property growth does provide new revenues). H.B. 920 is effectuated through the application of a lower millage rate (referred to as the effective millage) to the higher assessed value, thereby generating essentially the same amount of tax dollars.

The effect of H.B. 920 is to essentially eliminate any growth potential for roughly 81% of the District's revenue base. Any inflationary increase included in the State portion of the District's revenues provides only a very small portion of the needed revenue base. Consequently, the District's revenue stream remains relatively flat over the years, while its expense base (83% of which consists of salaries and benefits) continues to rise due to contractual and inflationary increases. In order to remain fiscally solvent, the District is forced to submit to District residents periodic requests for an increase in property taxes.

EVENTS OCCURRING SINCE THE LAST TWO OPERATING LEVIES

DISTRICT EDUCATIONAL ENHANCEMENTS

The Committee noted that since the passage of the two previous operating levies in 1992 and 1995, several educational program enhancements have been made by the school District:

- The implementation of an all-day kindergarten program;
- The redirection of resources to lower primary grade programs resulting in smaller class sizes;
- A kindergarten resource program implemented in 1997-98 which offers support for students who need additional skills development to maximize their success in kindergarten;
- The implementation in 1998-99 of a team teaching method in the middle school to facilitate the students' transition from the single classroom teacher approach utilized in the elementary schools to the departmentalized approach utilized in the secondary schools;
- The implementation of the Bridges program in the high school which offers a team teaching approach for ninth graders participating in either college prep or honors classes; and
- The implementation of extended day and extended year programs to provide additional instructional help to needy students, especially those experiencing difficulty with the Ohio proficiency tests.

DISTRICT OPERATIONAL EFFICIENCIES:

The Committee reviewed the expenses of the District by studying the assumptions utilized to develop the projections and by looking at expense trends. The District has continued to achieve cost containment through various methods:

- In 1995, the Board of Education unilaterally adopted cost containment caps so as to control the level of spending by limiting the total growth in expenditures to a pre-determined formula amount based on the CPI;
- The District has continuously monitored its health care benefit costs, and as a result the District has added a Preferred Provider Organization choice for its employees, which has a lower cost structure than the traditional comprehensive plan. Estimated annualized savings from this change amount to \$150,000;
- The District played a lead role in establishing a prescription drug consortium for governmental entities, which due to better discounts and negotiated agreements, saves the District an estimated \$60,000 per year;
- The District participates in the retrospective rating program for its workers' compensation requirements, and by so doing achieves substantial savings in premiums from 17% to 20% on an annual basis. Additionally, for the 1991, 1992, & 1993 workers' comp retrospective years, the District has saved approximately \$500,000 (excluding any interest earned on the set-aside funds during the intervening years) by participating in the retro plan vs. the premium-based plan offered by the Bureau of Workers' Compensation;
- The District participates in a purchasing consortium of school districts that brings quantity bargaining power to the group in order to obtain the best overall prices. The District uses the consortium to acquire its energy needs (including electricity and natural gas), business insurance for its liability, auto, boiler, and other insurance coverages and telecommunications program. Additionally, the District utilizes the consortium to acquire other large commodity items such as school buses, etc. Estimated annual savings resulting from the District's participation in the consortium amount to \$150,000; and
- The District engaged a consultant to perform an audit of all vendor payments made by the District for a specified period of time, for the express purpose of ascertaining whether overpayments had occurred. The results of the audit indicated that the District had achieved an accuracy rate which exceeded 99%.

NEW LEGISLATION & ASSOCIATED MANDATES

SCHOOL LEGISLATION:

Since 1995, significant legislation has been passed that places an even greater burden upon school districts throughout Ohio. House Bill 412 and Senate Bill 55 were referred to as the “fiscal accountability” and the “educational accountability” bills, respectively. Specifically, H.B. 412 requires districts to allocate a set percentage of their revenues to be spent on textbooks and other instructional supplies, capital repairs and maintenance, and on establishing a rainy day reserve. S.B. 55 calls for numerous educational mandates (primarily of the unfunded type), including a provision which mandates that fourth-graders be held back if they do not pass the reading portion of the fourth-grade proficiency test.

ELECTRIC UTILITY DEREGULATION:

Additionally, the State Legislature has approved a process whereby electric public utilities will be deregulated. The impact of such deregulation and its effect on the public utility tax revenues received by the District is yet to be determined by the Public Utilities Commission of Ohio (PUCO). Additionally, there are tax litigation cases in process, the outcome of which could be detrimental to the District’s ongoing fiscal health, due to the possible impact on utility property tax revenues.

REPEAL OF INVENTORY PROPERTY TAX:

Additionally, in mid 1999, the State Assembly approved legislation which will repeal the inventory portion of the personal property tax. Under the phase-out plan, the current assessment rate of 25% will be reduced 1% per year over a 25 year period. The District will lose over the 25 year period approximately \$500,000 annually that it currently receives from such tax.

JUDICIARY CASE:

Because of significant differences in State funding amongst the schools, the *DeRolph* vs. Ohio lawsuit was filed claiming the State’s educational funding system to be unconstitutional on the grounds that it failed to provide a thorough and efficient system of common schools throughout the State as called for in the Ohio Constitution. The Perry County Common Pleas Court Judge ruled in favor of the plaintiffs in 1994, and was overturned in 1995 by the Court of Appeals, which was in turn reversed by the Ohio Supreme Court in 1997. As part and parcel of the Supreme Court’s ruling, the State Legislature was required to submit a new funding system for review by the Perry County Judge. In early 1999, the Perry County Judge rejected such plan, declaring that the new system failed to meet the criteria set out by the Supreme Court. The latest ruling is currently on appeal to the Ohio Supreme Court, from which a decision is not expected until sometime in 2000. Such ruling, when in final form, may have substantial impact on the fiscal status of school districts throughout the State, including Shaker Heights.

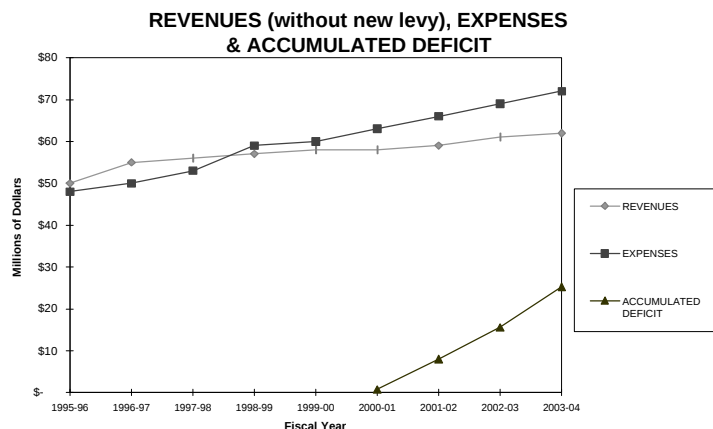
CONCLUSIONS & RECOMMENDATIONS

The Committee's conclusions were based upon the premise that the Board would choose to maintain the current high level of educational programming.

1. **The Committee concluded that the forecast assumptions used by the Treasurer are reasonable.** There are numerous variables that provide a level of uncertainty with regard to future events, such as the *DeRolph* case and its ultimate impact on how school districts are funded in the State of Ohio; the outcome of public utility deregulation; the cost of implementing the mandates set forth in H.B. 412 and S.B. 55; as well as the ever-increasing need for special education services. Given these factors, the assumptions reflect a high degree of probability of occurrence and therefore represent reasonable parameters upon which to base future decisions. Historically, the District forecasts have been reliable in view of this ongoing level of uncertainty.

It should also be noted that the assumptions incorporate the following factors which influence the overall school financial position: the increasing cost and incidence of special education needs within the District, which have increased to 12.2% of the fiscal 1999-00 budget as compared to only 10.8% of the fiscal 1995-96 budget (including out-of-district tuition which is currently 3.9% of expenses, up from 2.3% in fiscal 1995-96); the overall trend of increasing enrollment during the projection period, which is estimated to increase by about 312 students over the next five years, or 5.5% over the base year of 1998-99; the increase in and implementation of the various State mandates issued in recent years; and the fast-paced growth in health care costs. Even so, expenses are only forecasted to grow at a 4.4% average annual rate for the four years following the 1999-00 school year.

2. **The Committee concluded that the financial projections are reasonable. Consequently, additional operating revenue is needed in order to avoid a financial deficit, or alternatively a reduction in educational and operational services provided by the District.** During the 1999-2000 fiscal year, the District is forecasted to have operating expenses exceed recurring operating income by \$3.7 million or 6.6% of income. This large operating deficit is funded by depleting the accumulated surplus that was generated by annual operating surpluses in the three fiscal years following the last operating levy in 1995. The fiscal 1999-00 deficit is forecasted to reduce the carryover budget surplus to only \$4.8 million at June 30, 2000. This accumulated surplus amount will be insufficient to fund the currently forecasted operating deficit of \$5.6 million for fiscal 2000-01. Therefore, without a new operating levy in 2000, expenses would need to be reduced by an estimated 1.2% in fiscal 2000-01 and 11% from those forecasted for the 2001-02 fiscal year. Since a substantial portion of these expenses are mandated by state or federal law, negotiated by contract, and/or result from general inflation pressures, cuts of this magnitude could prove to be impossible but in any case



would severely damage the educational program. Although the Consumer Price Index (CPI) is generally accepted and understood as an inflationary index, it is more appropriate for a typical household than for educational institutions. Because over 80% of the District's expenditures consist of wages and related benefits, the District is typically subject to a higher inflation rate than that of the CPI. The District's historical expenditure growth rate has in fact mirrored those of other institutions in the educational arena.

3. **The Committee concluded that the District should continue to utilize bond levies to fund the District's capital needs.** The last two bond levies for capital improvements and repairs were approved in 1996 and 1990. For a decade before the 1990 bond levy, capital needs had not been addressed through bond levies. The forecast assumes that such bond levies will continue to be utilized to meet the capital needs of the District. The next bond levy is assumed to occur in the 2001-2002 time frame.
4. **The Committee concluded that the District should continue to pursue the identification and implementation of cost-saving measures so as to provide the most efficient and effective services possible, both educationally and operationally, without sacrificing educational integrity.**
5. **The Committee concluded that the District should evaluate and consider establishing criteria to be utilized to determine the optimal financial position point-in-time in which to place the next operating levy on the ballot.** The Committee noted that the District's expenditures actually exceeded its revenues in fiscal 1998-99 and 1999-2000. Although this is a common occurrence in school finance, this does not represent a private industry best practice. The Committee concurred that the District should begin the next levy process at the point in time when expenses begin to outpace revenues.
6. **The Committee unanimously and emphatically concluded that the District should place an operating levy on the March 2000 ballot so as to sustain the high level of educational service currently being provided.** Given the large magnitude of the current operating deficit, any delays in the request or passage of an additional operating levy of at least 9.4 mills would quickly cause significant reductions in current educational programs within the District.

ABOUT THE MEMBERS OF THE CITIZENS' FINANCE REVIEW COMMITTEE

Kim S. Cameron is Dean of the Weatherhead School of Management at Case Western Reserve University. Prior to coming to Cleveland, he served on the faculties of the business schools at the University of Michigan and Brigham Young University. His research interests include downsizing and redesign in private- and public-sector organizations, and organizational quality and performance in higher education and business. A former Fulbright Distinguished Scholar, he holds B.S. and M.S. degrees from Brigham Young University, as well as an M.A. and a Ph.D. from Yale University.

E. Pauline Degenfelder is Vice President of Post-Acute Care for The MetroHealth System and Director of The MetroHealth System Managed Care Program. Her responsibilities include strategy formulation, operations, managed-care contract implementation and network development. A Fellow of the American College of Health Care Executives, she holds a Bachelor of Arts from Cornell University and an M.B.A. and a Ph.D. from Case Western Reserve University. She served on the Citizens' Finance Review Committee in 1992 and 1994.

Robert L. Forward is president of Brown-Forward Funeral Home in Shaker Heights. A 1964 graduate of Shaker Heights High School, he holds a bachelor's degree in business administration from Norwich University and completed postgraduate work at the Pittsburgh Institute of Mortuary Science. He served for nine years as a trustee of the Shaker Schools Foundation, including three as its president, and currently serves on the board of the Shaker Historical Society. He served on the Citizens' Finance Review Committee in 1992 and 1994.

Reuben Harris, Jr., is owner of a State Farm Insurance agency. A Certified Public Accountant, he has held accounting and financial positions with KPMG Peat Marwick LLP, Forest City Hospital Association, and Gold Builders prior to starting his own business in 1989. He was a dean's list student at Cleveland State University, where he earned a bachelor's degree in accounting. He is co-president of the Shaker Heights High School Parent-Teacher Organization and a co-founder of Caring Communities Organized for Education.

R. B. "Yank" Heisler is President of Key Capital Partners, which provides brokerage, capital markets, insurance, investment banking and asset management to business and private clients. He previously served as president of Key PrivateBank and as president and chief executive officer of the former Society National Bank (now KeyBank). After a year-long assignment in Seattle, he and his family returned to Shaker Heights in 1995. He is a 1970 graduate of Harvard College and received an M.B.A. at Kent State University.

Edward P. Hemmelgarn is founder and chief investment officer of Shaker Investments. Prior to starting the company in 1991, he worked in mergers and acquisitions, accounting, commercial banking, and biochemical research. He is the former Chief Financial Officer of retail banking for Ameritrust Corporation. He also worked for Ernst & Young, focusing on strategic and financial management consulting. He holds a B.A. in chemistry and an M.B.A. from Case Western Reserve University and is a Certified Public Accountant. He is a trustee of the Shaker Schools Foundation.

Patrick M. Prout is a consultant with Heidrick & Struggles, an international executive search firm. Prior to joining the firm, he was Vice Chairman of Bank One, Cleveland, NA, where he had also served as President and Chief Operating Officer. His 22-year banking career included positions at Bank of America, Rainier Bank, and Chase Manhattan Bank. He currently serves on the boards of Hawken School, and The National Conference, and on the Visiting Committee of the Weatherhead School of Management. A graduate of the U.S. Naval Academy, he holds a master's degree in business administration from Harvard University.