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THE BUSINESS OF CHARTER SCHOOLING

UNDERSTANDING THE POLICIES THAT CHARTER
OPERATORS USE FOR FINANCIAL BENEFIT

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December 2015

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This work was made possible in part by funding from In the Public Interest (<http://www.inthepublicinterest.org>).

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Suggested Citation:

Baker, B. & Miron, G. (2015). *The Business of Charter Schooling: Understanding the Policies that Charter Operators Use for Financial Benefit*. Boulder, CO: National Education Policy Center. Retrieved [date] from <http://nepc.colorado.edu/publication/charter-revenue>

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THE BUSINESS OF CHARTER SCHOOLING: UNDERSTANDING THE POLICIES THAT CHARTER OPERATORS USE FOR FINANCIAL BENEFIT

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Executive Summary

This brief details some of the prominent ways that individuals, companies, and organizations secure financial gain and generate profit by controlling and running charter schools. To illustrate how charter school policy functions to promote privatization and profiteering, we explore differences between charter schools and traditional public schools in relation to three areas: the legal frameworks governing their operation; the funding mechanisms that support them; and the arrangements each makes to finance facilities. We conclude with recommendations for policies that help ensure charter schools pursue their publicly established goals and that protect the public interest.

In this brief, we identify four major policy concerns:

1. A substantial share of public expenditure intended for the delivery of direct educational services to children is being extracted inadvertently or intentionally for personal or business financial gain, creating substantial inefficiencies;
2. Public assets are being unnecessarily transferred to private hands, at public expense, risking the future provision of “public” education;
3. Charter school operators are growing highly endogenous, self-serving private entities built on funds derived from lucrative management fees and rent extraction which further compromise the future provision of “public” education; and
4. Current disclosure requirements make it unlikely that any related legal violations, ethical concerns, or merely bad policies and practices are not realized until clever investigative reporting, whistleblowers or litigation brings them to light.

In response to these policy concerns, we provide the following eight recommendations:

Recommendation 1: States should include in their charter statutes a broad declaration that charter schools are “public” and that all remaining provisions should be read to ensure that charter school students, parents and taxpayers waive no rights in their choice to attend a charter school or as a citizen whose tax dollars are allocated to a charter school.

Recommendation 2: Districts or other local public and government authorities should maintain control over public lands and facilities and should serve as centralized managers and stewards of facilities space to be used by both district and charter schools.

Recommendation 3: Authorizers should be required to review any large contracts between charter school boards and EMOs or outside firms. Most importantly, the authorizer needs to scrutinize and approve lease agreements and management agreements between charter school boards and private EMOs.

Recommendation 4: Financial reporting requirements must be expanded and elaborated to obligate the same degree of precision in revenue and expense reporting for charter schools as for government entities, and to obligate the reporting of EMO revenues and expenses, assets and liabilities.

Recommendation 5: State charter school laws should be revised to ensure that any and all meetings among officials of the school or its authorizing entity must follow public records and meetings laws. Further, all contracts between governing boards and management companies and between management companies and service providers should be publicly available. This includes posting of all employee or bargaining unit (if any) contracts, including any “taxes” imposed on employee wages.

Recommendation 6: On many levels, states should tighten regulations to ensure appropriate degrees of independence among interested parties. All relationships, be they between (i) school administrator and board members or key contractors such as EMOs; (ii) authorizers and school governing boards; (iii) governing boards and management companies; or (iv) management companies and contractors, must pass basic arm’s-length tests. Sound ideas regarding contracts with EMOs are found in a recently proposed bill in Connecticut.¹

Recommendation 7: States should more closely link public subsidy rates to relevant costs and needs and use fine-grained reporting of those needs and costs.

Recommendation 8: When contracting with EMOs, charter school boards should engage in “smart buying,” and authorizers should provide guidance and oversight to ensure that major contracts are in the interests of the public charter school. Good EMO contracts include the following types of provisions:

- At least two competing bids from EMOs;
- Length of contract no more than the length of the charter, and preferably less;
- Contingency plans so that the option of firing the EMO remains viable and realistic;
- Full disclosure of financial information and test scores to citizens, authorizers, and state officials;
- Budgeting for internal and external evaluations of school and EMO performance; and
- Ensuring that contracted EMO has no personal or professional connections with charter school board members.

It seems clear that the financial incentives embedded in state law, combined with the need for most of the companies to make a profit, have led EMO-run schools to operate in ways that are often at odds with the goals of charter school reforms and, ultimately, the public interest.

THE BUSINESS OF CHARTER SCHOOLING: UNDERSTANDING THE POLICIES THAT CHARTER OPERATORS USE FOR FINANCIAL BENEFIT

Introduction

This brief details some of the prominent ways that individuals, companies, and organizations secure financial gain and generate profit by controlling and running charter schools. To illustrate how charter school policy functions to promote privatization and profiteering, we explore differences between charter schools and traditional public schools in relation to: the legal frameworks governing their operation; the funding mechanisms that support them; and the arrangements each makes to finance facilities. We conclude with recommendations for policies that help ensure charter schools pursue their publicly established goals and that protect the public interest.

One purpose of this research brief is set a foundation for future work. In order to build this foundation, the brief summarizes literature and media coverage specific to this topic area. The brief also draws upon both authors' extensive experience and past research. Both have published extensively on the topics of charter schools, private EMOs, and school finance. Both have served as expert witness for legal cases dealing with privatization, self-dealing by EMOs, and school finance. And, both have also testified in state legislative and congressional hearings on this topic.

Background

In the early 1990s, charter schools were envisioned as a new form of public schools that would be small, locally run, innovative, and open to all.² The two most prominent promises associated with charter schools were increased accountability and improved performance, as measured by student achievement.

At the time, considerable attention was given to the anticipated (i.e., legislatively stipulated) goals of charter schools. Over the years scholarship and state evaluations of charter schools have found that charter schools do increase opportunities for educational choice,³ but they have not in the main developed as "locally-run," "innovative schools."⁴ Few if any policy-makers or advocates continue to argue that charter schools are creating new professional opportunities for teachers to direct their professional work.⁵ While advocates still assert that charter schools are more accountable than traditional public schools and that they outperform traditional public schools, these claims appear largely unsupported by the body of available evidence.⁶ The available evidence overall suggests that performance by students in charter schools and traditional public schools is very similar.⁷ Nevertheless, many studies and evaluations have also found that parents and students are generally satisfied with their charter school.⁸ When charter schools do fail to perform as expected, they are relatively rarely held accountable under the terms of their contracts. And, despite charter schools' track record being decidedly mixed, charter schools continue to proliferate even as an in-

creasing number of reports document questionable financial practices and highlight policies that fail to insure public money is being appropriately spent.⁹

Chartering as Policy Innovation

The simplest and most direct way to explain charter school policy is to provide an illustrative model. Figure 1 highlights key structural changes to public education introduced by charter school policy and the outcomes those changes were intended to produce.

The figure contains three parts. On the left are key statutory and/or policy changes that frame the legal, political, and economic environment in which charter schools operate. These changes open up opportunities for charter school experimentation.



Figure 1. Illustration of the Charter School Concept (Miron & Nelson, 2002)¹⁰

The primary mechanism by which charter school policy seeks to change schools' external environments is by creating competition and choice. Charter schools are schools of choice in that, with some exceptions, students from any district or locale within a given state may attend any charter school. Advocates of school choice argue that choice will lead to competition, spurring innovation and improving education quality and outcomes.¹¹ Choice will also, it is asserted, be an efficient mechanism for sorting stakeholder preferences. Such efficiency will in turn reduce the time schools spend resolving conflicts among school stakeholders, yielding more time and energy to develop and implement educational programs. Advocates of school choice also argue that the very act of choice will leave students, parents, and teachers disposed to work harder to support the schools they have chosen.¹²

The charter reform is different from many other education reforms in that it does not prescribe specific interventions. Rather, it changes the conditions under which schools develop and implement educational interventions. At the heart of the charter concept lies a bargain. Charter schools will receive more autonomy over curriculum, instruction, and operations than other public schools. In exchange, they must agree to be held more accountable for results—the outcomes articulated in the charter contract. In theory, if a charter school does not meet its stated goals, its sponsor can revoke its charter or refuse to renew it when the contract expires.

In theory, another form of accountability charter schools face is market accountability. Since charters are schools of choice and money follows the students to the schools they select, this theory suggests that charter schools failing to attract and retain students will go out of business. This competition, advocates argue, provides an incentive for charter schools to provide an attractive product, similar to the incentive felt by Pepsi or McDonald's.

Charter school accountability is for results, not for how the schools attain those results. The most commonly noted "final" outcomes or results for charter schools are student achievement and customer satisfaction (as indicated in Figure 1).

Charter School Growth Since 1990

Since its origins in the early 1990s, the charter school sector has grown to over 6,500 schools serving over 2.25 million children in 2013.¹³ In some states, the share of children now attending charter schools exceeds 10% (Arizona, Colorado), and in select major cities that share exceeds one-third (District of Columbia, Detroit, New Orleans).¹⁴

Whatever its original purposes, charter school policy has proven to be a primary mechanism for privatizing public schools and public school functions. Within a decade of the first charter school legislation being passed, for-profit education management organizations (EMOs) became the largest players in the charter school sector.¹⁵

By the early 2000s investors and philanthropic groups were shifting their attention from the high profile for-profit EMOs such as Edison Schools Inc.¹⁶ and beginning to focus on non-profit education management organizations as the best vehicle for organizing and promoting charter schools. Support was directly given to the nonprofit EMOs and increasingly the support was channeled through the New Schools Venture Fund (NSVF). The NSVF called the subgroup of nonprofit EMOs that it supported Charter Management Organizations (CMOs). CMO refers to a small group of nonprofit EMOs whose purpose is to bring what are deemed as successful charter models to scale.¹⁷ In this report we use the term EMO to denote private companies and organizations that operate charter schools. EMOs can be for-profit or nonprofit. While the non-profit CMOs tend to provide schools more resources than they consume, they are generally an exception. Most nonprofit EMOs look, act, and have management agreements similar to for-profit EMOs.¹⁸

In total, it is estimated that between 35 and 40 percent of all charter schools in the United States are now operated by EMOs.¹⁹ Because these schools tend to have larger enrollments than average charter schools, they account for close to an estimated 45% of all charter school enrollments (see Figure 2).

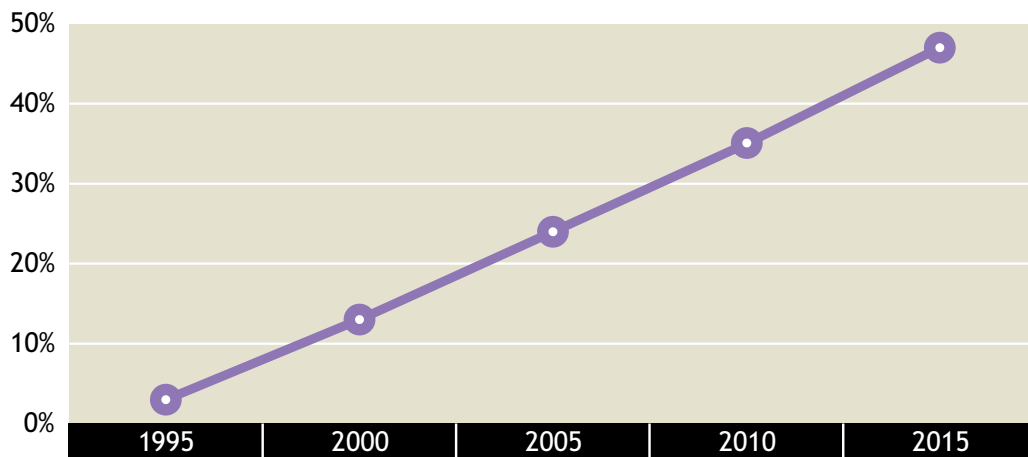


Figure 2. Percentage of All Public Charter School Students Enrolled in Privately Operated Charter Schools

Source: Data and estimates are based on NEPC’s 14 Editions of Profiles of EMOs.²⁰

EMOs currently operate in 35 states. For-profit EMOs dominate the charter school sector in Michigan, Florida, Arizona, and Ohio; nonprofit EMOs are most prevalent in Texas, Illinois, New York, and California.¹⁰⁹

In 2014-15, close to 100 for-profit EMOs ran more than 900 charter or district schools across the U.S. and approximately 300 nonprofit EMOs operated more than 2,000 charter schools.²¹ Although our enrollment figures are still tentative, we estimate that in total EMO-operated schools enroll over 1.2 million students.

Differences in Individual Rights, School Governance, Finance and Disclosure

Increasingly complex governance structures for charter schools provide the financial and legal frameworks shaping charters’ financial management and disclosure. Charter frameworks vary substantively from frameworks governing traditional district schools, generating differences in the flow of money into and out of schools as well as differences in how the two sectors finance the acquisition of such capital assets as land and facilities.

Individual Rights in Traditional District Schools and Charter Schools

Distinctions between “public” and “private” entities raise important public policy concerns, and the charter sector’s evolution and expansion raise numerous questions regarding the rights of students, parents and taxpayers.²² Three broad policy arguments typically underpin advocates’ promotion of unfettered, deregulated charter school expansion and charter

school replacement of district schools—and even entire local public school districts:

1. Unlike “voucher-receiving” private schools, charter schools are considered “public” schools even if operated by private entities.²³
2. The public (or state) interest rests not in who operates or governs charter schools, but rather in positive changes in student outcomes that can be achieved regardless of governance and organization of the provider. This premise is referred to as “sector agnosticism.”²⁴
3. Accepting both premises above, government actors must be willing to “relinquish” government operated institutions to private providers and private parental choices in order to increase options available to parents/children and produce desired gains in student outcomes.²⁵

To a considerable extent, these policy arguments are divorced from the legal realities of mixed governance models for the provision of public services, including elementary and secondary education. Through legal challenges brought in both state and federal courts over the past few decades, we have learned that:

- Private entities and individuals may not be subject to the same financial or other document/records disclosure laws that apply to state operated entities and public officials.
- Employees of private entities are not guaranteed the same constitutional (and some statutory) protections they would be guaranteed under contractual arrangements with state operated institutions. Moreover, private entities operate under different labor laws than state operated ones.
- Students attending privately governed entities are not guaranteed the same constitutional (and some statutory) protections they would be guaranteed while attending state operated institutions.²⁶

Transparency laws adopted by state legislatures requiring open meetings, public access to records and financial disclosure commonly apply to public officials and state operated institutions. However, courts across states have offered mixed opinions as to whether and to what extent those laws apply to charter schools, their authorizers, operators and governing boards.²⁷

In addition, the U.S. Constitution prohibits the government or its agents from violating individuals’ rights to free speech, due process, and freedom from unreasonable searches. Therefore, students and employees in public schools maintain these constitutional rights. In contrast, students in schools run by private entities, or employees engaging in contractual arrangements with private entities, may not enjoy the same protections.²⁸ In many of these cases, employment contracts or school discipline policies provide employees or students (and their parents) only the rights guaranteed under private contract law.

Governance and Funding in Traditional District Schools and Charter Schools

Figure 3 compares several delivery structures for the provision of publicly subsidized elementary and secondary education in the U.S. The shapes in the figure with orange backfill

are public, or government operated institutions. The bottom two institutions in green shading are decisively “private” entities, such as private religious schools. Those institutions with characteristics of both public and private organizations are shaded in blue. For simplicity, Figure 3 excludes other permutations, including relatively new “education savings accounts,” a variation on voucher and tax credit policies.²⁹

As the left side of the diagram indicates, district operated schools are governed by boards of local elected public officials and financed primarily by taxpayers. District schools typically receive a mix of state aid and local (often publicly approved) property taxes, and/or sales and income taxes. The state aid typically comes from income and sales taxes, as determined by state policies. Tax monies collected by state and local government agencies are, of course, public funds.

As indicated on the right side of Figure 3, however, some structures—the Cleveland and Milwaukee voucher programs, for example—allow financial subsidies to be provided directly to private schools. Under these models the schools remain “private” entities, not branches of government itself. But whether they receive public subsidies directly or not, voucher-funded private schools are unlike government operated schools in that they may promote or endorse specific religious values, can restrict student or employee freedom of speech/expression, and need not provide due process in cases of dismissal, unless explicitly required in laws for voucher receiving institutions.

Recently, direct subsidy voucher models have been replaced by tuition tax credit models which insert an additional layer of private governance. Instead of the government providing taxpayer dollars to private institutions, individuals and corporations receive a tax credit for contributing money to a private scholarship granting entity, which in turn provides vouchers. Assuming a 100% tax credit for money donated, the result is mathematically the same as if the government provided the voucher directly. However, the involvement of another private, non-government actor in the flow of funds further limits taxpayer ability to challenge the distribution of tax-related funds.³⁰ And, the schools receiving students funded by the scholarships remain clearly private.

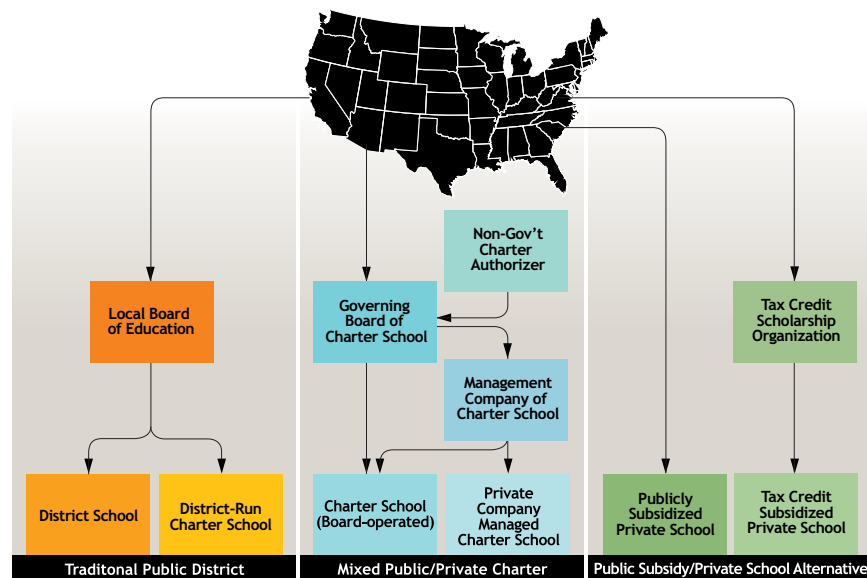


Figure 3. Alternative Governance Hierarchies

The middle of Figure 3 illustrates other governance options that occur under state charter school statutes. Charter schools are authorized to exist by an entity called an “authorizer”—either government itself or another entity with delegated authority. Charter schools are “authorized” to establish themselves as institutions eligible to receive taxpayer financed subsidies in order to provide elementary and secondary education to eligible children. The state may draw on its tax revenues to pay subsidies directly to “fiscally independent” charter schools. Or, the state may send its subsidies to local public school districts, which then pass on to charters a combination of state tax revenues and locally derived tax revenues. That is, under state charter school laws, districts that are geographic hosts to charter schools may be obligated to transfer to those schools both funds sent to the district by the state and funds raised from local property taxes. One permutation not depicted in Figure 3 allows local boards of education to authorize a charter school to operate independent of district governance (Wisconsin). Another permutation allows state approved authorizers to include such

The multiple layers of private school operations and management, governing boards of private citizens, and in some cases, authorization by private entities, presents far greater opportunity to shield documents and avoid constitutional and statutory protections in the charter sector.

other public entities as universities, mayors, city councils, county boards and so on.

Other variations exist in state approaches to authorizing charter schools. In some states, the state agencies themselves exclusively determine who may operate a charter school, where that school may be located and who is eligible to attend. In other states, local public school

districts may authorize establishment of charter schools within their jurisdiction. In both of these cases, the authorizing body remains “public,” and subject to the relevant legal obligations of public officials and government institutions.

Other states, like Ohio, permit private, non-government entities to serve as authorizers. That is, the state delegates responsibility for determining what entities should qualify for taxpayer subsidy. These authorizers are governed by boards of private citizens, not elected officials. As a result, their meetings, various activities, documents and so on may be shielded from public scrutiny, depending on case law and specific statutes in the state. Authorizers typically have the authority and responsibility to allow, renew and revoke charters. Public accountability of this system depends up authorizers and charter operators being independent entities.

Charter school operations and governing bodies also take many forms. In most states, charter school governing boards are appointed boards of private citizens, like those governing any private non-profit (and in some cases for-profit) institution. State laws vary in terms of how much private governing boards must disclose about their activities and documents as compared requirements for public entities. In theory, as would be the case with a non-profit private school, an individual or group of “founders” would seek and appoint a board of directors who would then collectively establish the mission and vision as well as bylaws of the institution. Just as a pending private school might seek accreditations and/or other endorsements (association membership, for example), the charter founders would apply to an authorizer for a charter to enroll students and receive the taxpayer subsidized funds that come with them.

Charter school governing boards may appoint school executives/leaders/managers, or al-

ternatively they may contract with a private non-profit or for-profit management company, to handle some or all of the day-to-day operations of the school. For example, the charter school governing board may establish a contract with the private management company to both directly manage the school and to engage in all subsidiary contractual agreements; in this arrangement, the employer is the management company, not the school governing board. Any additional contracts, such as with food service providers or busing companies, are between the private management company and these subcontractors. That is, the governing board maintains only one contract, involving the transfer of the majority or all taxpayer subsidies to the management company, which then controls all other subcontracts. In such cases, only the single lump sum payment to the management company may be subject to public scrutiny, since all other contractual agreements are between private entities—if the charter governing board’s expenses are subject to public scrutiny at all. Further, agreements to abide by school discipline policies may be established between the private management company and parents, avoiding any role for public officials and government institutions and limiting students’/parents’ potential legal recourse.

Maintenance of public accountability relies on the presumption that any charter school’s (or any business entity’s) board of directors is sufficiently independent of the contracted private management company that it may sever ties with that contractor and seek alternatives for school management, if necessary.³¹

Local public districts can also contract, and have contracted, private management firms to operate some or all schools within their jurisdictions.³² So too could private schools. But when public districts have contracted private management in the past, districts have maintained collective bargaining agreements for those teachers and other employees in schools operated by private contractors.³³

Traditional districts also contract with private for-profit busing companies, food service providers, providers of curricular materials, data management products and professional development programs. Employee contracts in these areas are unlikely to be subject to public scrutiny. Similarly, details of such expenditures may be shielded from public view.³⁴ Such is the nature of complex public-private business relationships.

It is not clear if a traditional district, governed by a board of elected or appointed public officials, could use private managers to shield themselves from disclosure requirements or violations of the constitutional rights of students, parents or employees. The multiple layers of private school operations and management, governing boards of private citizens, and in some cases, authorization by private entities, presents far greater opportunity to shield documents and avoid constitutional and statutory protections in the charter sector.

Table 1 summarizes key distinctions between traditional public school districts and privately managed, privately governed charter schools.

Table 1. Key Differences in Traditional Districts & Charter Schools

Dimension	Local Education Agency	Privately Governed Charter (Non-State Actor)
Governance	<p>Governed by public officials (with all rights & immunities)</p> <p>Elected or appointed</p> <p>Subject to open public records & open meetings laws</p> <p>Required to comply with public bidding requirements</p>	<p>Governed by appointed (self-appointed) board of private citizens</p> <p>May not be subject to open records or meetings laws</p> <p>May not be required to engage in public contract/bidding requirements</p> <p>Private appointed board may hire private management firm</p>
Disclosure	<p>Required to disclose finances (reported relatively consistently in most state data systems, including detailed AFRs (annual financial reports) & public posting of budgets)</p> <p>Public officials subject to open meetings laws</p> <p>All documents/employee contracts/financial documents & communications between officials subject to open records laws.</p>	<p>Usually required to report expenditure of public funding. State data systems spotty and inconsistent on charter school revenue/spending data (may be required to disclose IRS filings [form 990])</p> <p>Board members & managers may not be subject to open meetings. Many documents/contracts with private manager, etc. considered private/proprietary.</p>
Individual Rights	<p>Public employees with key constitutional and statutory protections</p> <p>Retain rights to not have their government (school) infringe on various constitutional and statutory rights, and to uphold key statutory obligations.</p>	<p>Private employees may forgo certain rights to bring legal challenges against their employer</p> <p>Students may forgo numerous rights under privately governed discipline codes.</p>

Disclosure Requirements in More Detail

Financial disclosure and reporting issues resurface throughout this brief, and thus warrant some additional attention here. There are a handful of types of publicly reported financial documents from which we might gain information regarding a) revenues and expenditures, and b) assets and liabilities of district, charter and private schools or entities involved in managing/governing them.

Data on public districts can be extracted from the following reports:

1. Annual budgets of revenues and expenditures for coming year
2. Audited annual financial reports (AFR)

- a. Revenues and expenditures
- b. Assets and Liabilities
3. Statewide (public employee) staffing reports
4. Census Fiscal Survey mapped collection of state and district Annual Financial Report (AFR) data

In contrast, there are fewer and less detailed sources of information on non-profit governed charter schools and charter management organizations:

1. IRS form 990
2. Audited annual financial reports (in some states and under select authorizers)
 - a. Revenues and expenditures
 - b. Assets and Liabilities

For publicly traded for-profit charter management companies, only one source is available:

1. Securities and Exchange Commission Filings

And for privately owned for-profit charter management companies, there may be no publicly available detailed financial reports.

These document types vary widely in the precision and type of information reported, making it difficult to construct apples-to-apples comparisons across district, non-profit and for-profit charter schools. Further, as discussed extensively by Baker, Libby and Wiley (2012), since many charter schools include layers of non-profit organizations with resources flowing between them, it can be difficult if not implausible to gain a comprehensive picture of all resources associated with any given school.

In contrast, local public school districts in most states are required to post proposed and adopted budgets of anticipated revenues and planned expenditures for the coming fiscal year (beginning July 1). Local boards of elected officials, in public hearings and in some cases with public referendum, then approve the budgets. In most states, local public school districts and local governments are also required to publish annual financial reports, with external audits sometimes required annually or biennially. These are also made publicly available, and generally comply with or may be mapped to U.S. Census Bureau financial reporting categories.³⁵ In many states, the public can access statewide (Comprehensive Annual Financial Report, or CAFR) databases of the line-by-line expenditure data for all local public school districts. In some states charter school data are included, but where charter schools are managed by private companies, the companies' expenses are not disaggregated.

Further, many states also collect detailed data on public school staff, qualifications, assignments and salaries (in New York, the Personnel Master File; in New Jersey, the Fall Staffing Report; and in Illinois, the Teacher Service Record). While these statewide staffing files include information on all public district teachers, administrators and other certified staff (in some cases, non-certified staff as well), they do not include comprehensive data on CMO/EMO employees.

Some states require external audits of district annual financial reports, also publicly available, and some states require independent audits for charter schools. However, the public accessibility of such charter school documents often depends on authorizers. Baker, Libby and Wiley (2012) point to the State University of New York's Charter School Institute as a model.³⁶ But even in the best case, these financial audits produce far less detailed informa-

tion on expenditures and salaries than public district state data systems. Further, Baker, Libby and Wiley (2012) explain that the regularity with which charter school operators make their financial statements available (through popular non-profit data collection entities like Guidestar and Foundation Center) varies widely from state to state.

Where state laws require charter school local governing boards, and perhaps the management companies they contract, to establish themselves as private non-profit entities, these entities file non-profit organization tax returns, or IRS form 990. These forms include far less detailed information on expenditures; for example, they may list only major grantees to which lump sums are disbursed. They do include data on the highest paid employees, but not on all employees. Thus, these reports are of little value in understanding where exactly money goes, but they may be of some value for understanding total resources, assets and liabilities, governance structures, organizational relationships and executive salaries.

SEC filings on publicly traded for-profit management companies provide even sketchier information, and we do not rely on them herein.

Muddy Water: The Difficulty of Tracking the Source of Revenues and the Flow of Expenses for Charter Schools

Just as the complexity of public-private governance emerging in the charter sector complicates analysis of legal rights and responsibilities, it also complicates analysis of how money flows into and out of charter schools. As noted above, there are two basic models of charter school public financing: (1) the direct state financing of fiscally independent charter schools and (2) the pass-through model for fiscally dependent charter schools, which involves local public school districts passing along a per pupil subsidy to charter schools. In the latter case it is not uncommon for the local public school district to retain certain financial responsibilities, such as the provision of transportation services, or costs associated with special education. Districts may also be responsible for providing curricular materials, enrollment management, or even access to facilities.³⁷ In such cases, appropriate corrections to the calculation of funds provided to charter schools for their annual operations are in order. In this analysis, we focus specifically on revenues and expenditures for annual operations—that is, the money needed to pay staff, keep the lights and heat running, purchase perishable materials and supplies, and provide any/all other services needed to keep the school running on a day-to-day basis. In the next section we address the emerging complexities of capital investment and acquisition.

On the revenue side of the picture—the left hand side of Figure 4—we see that traditional public districts rely on a mix of federal, state and local revenues. Local revenues are derived primarily from local property taxes, which may or may not be subject to annual local voter approval. Typically, increases in local property taxes to support operating revenue beyond a specific amount require local voter approval. State aid for local public school districts is determined through a general aid allocation formula. Federal aid that actually reaches individual schools comes mainly in the form of Title I (Elementary and Secondary Education Act) aid, targeted to schools serving larger shares of low income children.

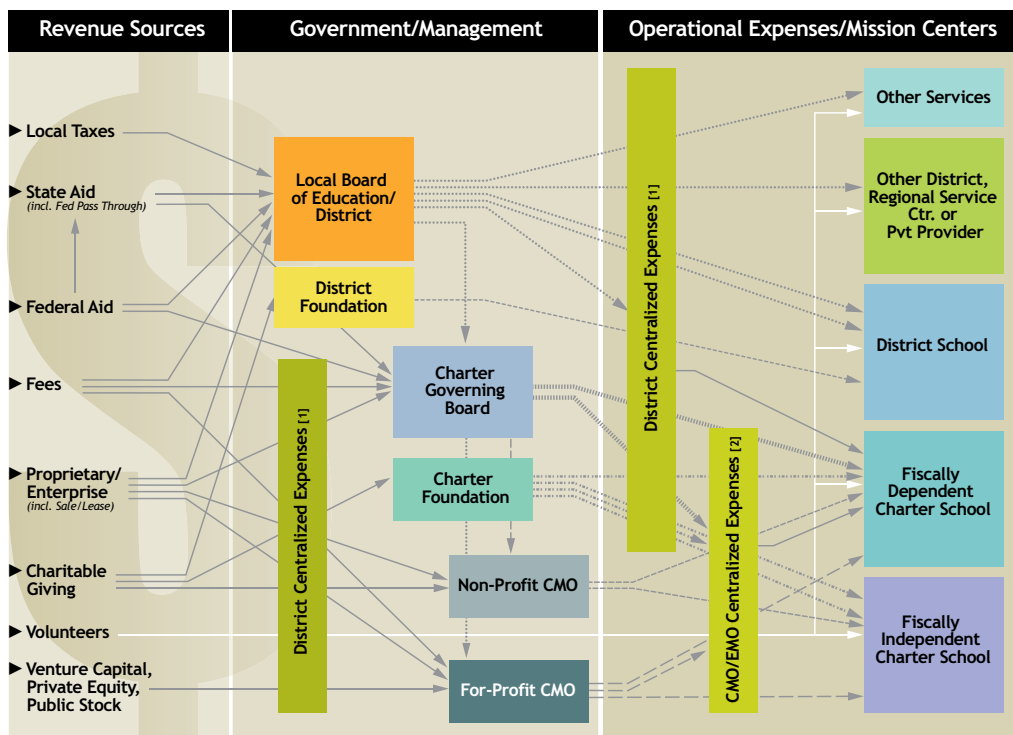
Depending on state restrictions, local public school districts may generate additional revenues by charging fees for materials and supplies, or for participation in activities. Local public school districts may also generate revenue from events, from leasing facilities, and from private grants and individual contributions, though these tend to represent relatively

small shares of district revenues.³⁸ Charter schools have access to largely the same revenue streams.

Whether in direct subsidy or pass-through models, the amount of state funding that reaches charter schools depends on state laws, which typically employ formulas that are tied to enrollments and that vary widely by state. Some charter schools raise much larger shares of their revenues from private contributions.³⁹ As discussed in more detail later, some charter schools have pushed the boundaries of permissible alternative revenues by, for example, charging fines for student disciplinary infractions, or obligating parents as a condition of enrolling their children to volunteer for such activities as cleaning the school.⁴⁰ Volunteers are considered an alternative revenue stream because their efforts create an opportunity for reducing the expense that would have otherwise occurred.⁴¹

Moving toward the expense side of the puzzle (see Figure 4), public districts may govern expenditures either in a highly centralized or in a decentralized manner. The largest share of school expenditures goes to employee compensation. In most cases, employee contracts are held between teachers, administrators, custodians, food service workers, and bus drivers (or the bargaining units that represent them) and the local board of education. Even under decentralized budgeting, this is most often the case. Whether local boards of education (advised by their hired leadership teams) allocate staffing lines to individual schools or provide contractual per pupil staffing budgets, the vast majority of expenditures, down to line items, are authorized by local boards of elected or appointed public officials. Negotiated agreements and actual individual salaries of public employees tend to be readily publicly available in electronic format,⁴² although some expenses may be aggregated under “contracted services.”

Figure 4. Operating Resource Flow



Charter schools may organize themselves as a single entity or as multiple related entities. They may, for example, establish a separate non-profit “foundation” through which they channel private contributions, or they may channel private contributions directly through the charter school as a non-profit entity.⁴³ If the charter school itself is established as a non-profit entity, or if an independent non-profit foundation is established, the school is able to receive tax exempt contributions, even if the school’s governing board decides to hire a for-profit company to handle day to day operations.

As explained above, local charter boards may hire an EMO (national or regional) to handle daily operations of their school. In doing so, the charter governing board either pays a management fee to the management organization, or transfers all or nearly all of its public subsidy to the control of the school manager. The manager then uses the subsidy to pay the management organization (itself) for its services; in this way, the management fee then flows back upward, as revenue to the governing regional or national management organization.

In the case of fiscally dependent charter schools—those operating under district control and receiving pass-through subsidy—employing an EMO would seem to create duplicative administrative costs. Other authors have pointed out that in the pass-through model, where districts retain certain financial responsibilities for charters, introducing charter networks can create administrative redundancies. Bifulco and Reback (2014) explain that “operating two systems of public schools under separate governance arrangements can create excess costs.”⁴⁴

These excess costs can be difficult to track since education management organizations do not report relevant, detailed, comprehensive expenditures in the same format or with comparable documentation as public districts or the charter schools themselves. One example comes from the IRS 990 form for the Uncommon Schools network, which operates North Star Academy in Newark, NJ. It reported 2012 compensation for its systemwide CEO approaching \$270,000, for its CFO at \$207,000, for its Senior Director of Real Estate at \$130,000, and for the Newark managing director at \$213,900; in addition, the network maintains school-level administrative staffs. These EMO salaries, presumably subsidized by management fees, are not accounted for in state professional staffing reports or in the schools’ own expense reports, and they may not be fully accounted for by the management fees listed in financial reports, where they are typically shown as central administrative contracted service expenses.⁴⁵ Administrative costs for the academy are also borne by the Newark Public School district, which has a separate districtwide administration. Thus, it is no easy task to determine exactly what the various administrative expenses for the North Star Academy actually total.

Several states assign to authorizers a percentage of public revenue designated for charter schools to pay for their oversight. In Ohio, authorizers also get a 3% cut off the top, and are presently lobbying to ensure that they are not required to disclose detailed expenditure reports on that cut.⁴⁶

Put simply, the increased complexity of charter school governance relative to traditional district governance makes it highly likely that the subsidies that actually reach the school site—the primary mission centers in question—are reduced in the process of financially sustaining various intermediate layers. Further, at various points in this system, public expenditures are transferred to the control of entities where public transparency may be compromised, including the possibility that all or nearly all public monies are transferred as a lump sum to the control of a private actor not required to provide detailed expenditure reports.

Accessing and Spending Money: Charter School Operating Budgets

Finding Money

Whether money is needed to make lease payments or to pay management fees, money for such charter expenses has to come from somewhere. Most commonly it comes from reductions in more typical classroom expenses, including teacher salaries and benefits, or materials, supplies and equipment. Figure 5 below provides a simplified view of the school budgeting puzzle, elaborated further in Figure 6.

It is important to understand that resources for these expenses can be “found” in one of two ways: either by revenue enhancement strategies, or by cutting expenses elsewhere. That is, either grow the pie, or cut smaller slices. And, as noted previously, traditional public school districts also engage in many of the same revenue enhancement strategies addressed here, including raising private contributions through local education foundations.⁴⁷

Charter schools might enhance revenues to cover rent payments, management fees, or otherwise manipulate or divert expenditures, through the following strategies:

- Aggressive private fundraising (for non-profit entities) or seeking private investors (for for-profit entities);
- Use of in-kind services, including parent volunteers;
- Charging participation fees for certain activities; and
- Maximizing advantages and incentives through state aid formulas.

Each of these activities can be done within legal and ethical boundaries, or stretched beyond. Two examples of pushing those boundaries include:

- Some charter schools have been found to condition continued student enrollment on parent volunteer activities;⁴⁸ and
- Others have been found to charge exorbitant fines for student disciplinary infractions.⁴⁹

One example involves head count. In many states, fall enrollment (typically calculated on the fourth Friday of the school year) is used to allocate funding for the school year. Charter or district schools retain revenue for students who dis-enroll, even if they dis-enroll prior to the start of the school year, creating an incentive for schools to maximize fall headcount enrollments. To the extent that mid-year dis-enrollments are greater in charter than district schools, charters may have greater opportunity to benefit from these policies. Other ways to take advantage of state policies have been found. In Pennsylvania, for example, for each child with a disability served in a charter school, the host district must send the charter funding at the average annual cost of serving children with disabilities, creating an incentive for charter schools to enroll large shares of children with mild disabilities.⁵⁰ While one cannot necessarily blame charter operators for wanting to take advantage of these policy flaws, these activities and the policies that permit (if not incentivize) them raise concerns.

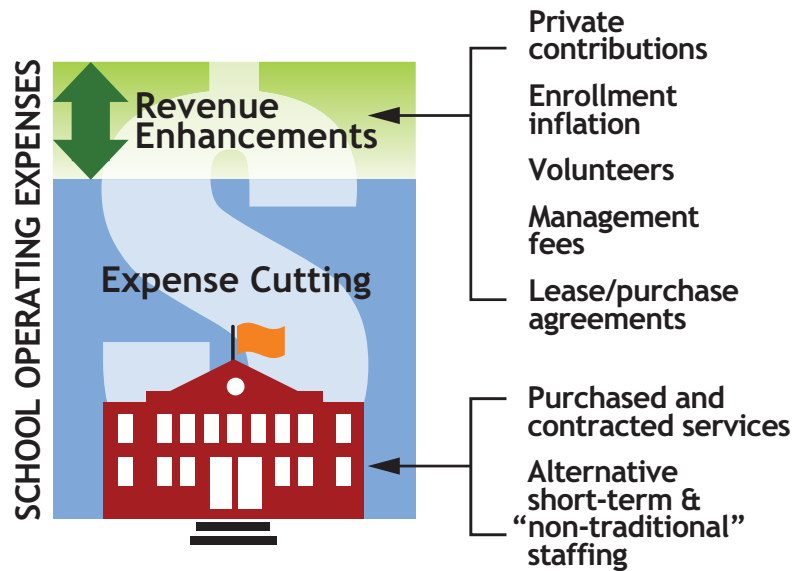


Figure 5. Accessing Operating Revenue

“Finding” Money by Not Serving Children with More Severe Disabilities

One strategy among charter providers across settings is to avoid serving children with more severe, more costly disabilities. Serving these children places significant pressure on the expenditure side of school budgets, since state aid formulas and federal subsidies for serving children with disabilities typically fall well short of actual costs. Note what has happened in Pennsylvania, where charter schools serving children with mild disabilities receive funding from their host districts at the *average* rate of per pupil special education spending in the districts. That is, the state provides an incentive for charters to serve children with disabilities, but only less costly ones.

Testimony prepared by Bruce Baker on behalf of Chester Upland School District for a federal district court in Pennsylvania showed the effects of this policy on the district’s finances. The district is home to a large charter school—Chester Community Charter School—which serves relatively large shares of children with disabilities. But 2008-2009 data showed that while 69% of children with disabilities in the district had mild specific learning disabilities or speech impairment, the charter school population of such children was 92%. By serving low need special education students but being reimbursed at the average cost for all special education students, Chester Community Charter School was both enhancing revenues and cutting expenses.

Similar disparities are revealed in more recent data from Newark, New Jersey. Notably, New Jersey’s special education financing formula does not include a revenue enhancing option akin to that in Pennsylvania. However, it is still in the interest of charter schools to reduce expenses by serving only the lowest need children with disabilities—if they serve any special needs children at all. Table 2 shows that overall, children with special needs comprise approximately 14% of the Newark district’s enrollment. Total special education enrollments in the city’s two largest network charters, however, are reported at 9% and 13%. Looking in particular at TEAM Academy charter school’s 13% is illustrative. While on the surface it appears that TEAM Academy serves a reasonable share of children with disabilities, more fine

grained data show that 76% of that school's children with disabilities have only mild specific learning disability or speech impairment, in contrast to 53% for district schools. Clearly, the related expenses associated with basic legal compliance in the provision of special education are much higher on a per pupil basis in the district. In particular, serving children with more severe disabilities creates substantial additional staffing expense.

Table 2. Special Education Enrollments by Disability Type in Newark, NJ

		NPS	North Star (Uncommon) Academy	Robert Treat	TEAM (KIPP) Academy
Total Enrollment		36,427	2,222	571	1,786
AUT	Autism	344	0	0	0
DB	Deaf Blindness	0	0	0	0
EMN	Emotional Disturbance	271	0	0	8
HI	Hearing Impairment	39	0	0	0
MD	Multiple Disabilities	553	0	0	0
ID	Intellectual Disability	221	6	0	0
OHI	Other Health Impairment	1,017	26	0	47
OI	Orthopedic Impairments	0	0	0	0
SLD	Specific Learning Disability	2,064	104	0	147
SPL	Speech or Language Impairment	696	53	20	32
TBI	Traumatic Brain Injury	12	0	0	0
VI	Visual Impairment	0	0	0	0
Total % Disability		14%	9%	4%	13%
% Disability that are SLD/Speech		53%	83%	100%	76%
Special Education Data http://www.nj.gov/education/specialed/data/2013.htm					
Enrollment Data http://www.nj.gov/education/data/enr/enr13/					

Some have suggested that charter schools appear to serve smaller total shares of children with disabilities not because these children are counseled away from applying or are pushed out, but rather because non-disabled children in early grades are less likely be classified if they attend charter schools.⁵¹ That is to say, district schools are overzealous in their classification of children on the margins, or those with mild specific learning disabilities and/or behavioral problems. This would be an unlikely explanation, however, for the patterns shown above, or in Chester Upland school district in which charter schools serve far fewer children with more severe disabilities.

Finding Money by Cutting Labor Expenses

When revenue enhancement strategies have been fully tapped, charter operators must seek to reallocate existing expenditures. Schooling is a labor intensive industry. The majority of education spending is tied up in salaries and benefits of employees, largely those of teachers. So if one wants to make profit on providing schooling, or if one wants to divert significant resources to management organizations, real estate dealings, or other business ventures, then one has to find ways to tap available resources, which may eventually include teacher

salaries and benefits.

The four boxes clustered to the left of Figure 6 indicate national average expenditures for traditional public districts and illustrate what percentage of the total is typically allocated to various expense categories. Assuming these proportions remain fixed, then management fees, consulting arrangements, lease agreements and any/all other diversions of expenditures must come from the relatively small shares allocated as miscellaneous (totaling 17.2%) in Figure 6. But, those shares also include such basic necessities as textbooks, computers, food, transportation, utilities and other non-wage maintenance and operation costs. The big money, so to speak, is in salaries and benefits. But this money tends to be more difficult to tap or cut. However, a number of creative as well as some more common strategies are emerging.

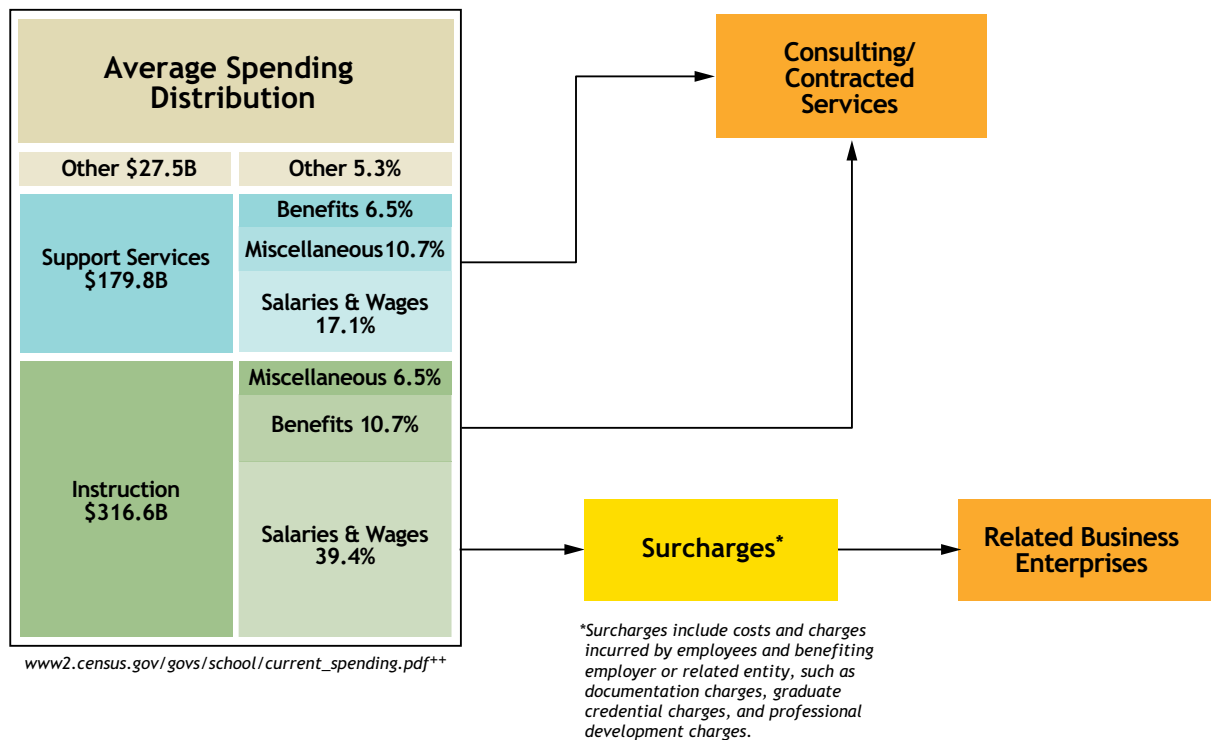


Figure 6. Tapping into Schooling Expenditures

We return to Figure 6 below, but in the interim Table 3 provides an example, using two sources of Texas school expenditure data, of the very different approaches of two nonprofit education management organizations—KIPP and Harmony.⁵² Specifically, Table 3 contrasts the revenues and expenditures of charter schools relying primarily on revenue enhancement versus those relying on expenditure cutting to free up resources for “other” uses.

KIPP’s primary approach to supporting its various additional costs is one of revenue enhancement, whereas Harmony’s is one of salary expense reduction. Publicly subsidized revenues in Texas charter schools and in urban districts are relatively consistent. Nonetheless, KIPP schools in Texas in 2013, on average, increased their operating expenses by nearly 20%. While major urban district schools, other charter schools, and Harmony schools spent around \$8,500 per pupil, KIPP schools reported spending \$10,280—a conservative figure

that likely misses some additional spending by KIPP's regional and national organizations on Texas KIPP schools. Despite the higher revenue, Table 3 indicates that KIPP's instructional spending was second lowest. Harmony's was lowest: even though in comparison to urban district and other charter school its total operating expense was lower, Harmony still spent a smaller percentage on instruction.

Despite having the highest total operating expense, KIPP schools diverted the largest shares to both central and school leadership activities. And, while Harmony's central administrative expenses were lower than "other" charter schools as a share of operating expense, its "plant services" expenses were noticeably higher, approaching 20% of operating expense.

The Harmony Schools example suggests that if those schools had spent the same percentage on instruction as other Texas charter schools, they would have spent nearly \$5 million more on instruction. Had they spent the same share of resources on salaries as other Texas charter schools, they would have spent over \$10 million more. These are the margins Harmony Schools made available to spend on *something else*.

Table 3. Texas Snapshot 2013

	Major Urban District	Other Charter	KIPP	Harmony
<i>Students</i>	967,480	140,646	12,220	24,616
<i>Per Pupil</i>				
Operating Total	\$8,429	\$8,648	\$10,280	\$8,359
Instruction	\$4,943	\$4,470	\$4,300	\$4,118
<i>Percent of Operating</i>				
Instruction %	58.74	52.55	41.87	50.15
Central Admin %	5.07	13.34	14.85	8.34
School Leadership %	5.96	8.07	11.47	10.19
Plant Services	10.97	14.06	13.60	19.04
Other	19.29	11.99	18.27	12.31
<i>FAST TEXAS data by Object</i>				
Operating Total	\$8,349	\$8,578	\$10,161	\$7,242
Payroll per Pupil	\$6,804	\$5,314	\$6,018	\$4,139
Other Operating	\$1,682	\$3,293	\$4,191	\$3,103
<i>FAST TEXAS Percent</i>				
Payroll percent	63.70	58.81	55.44	53.17
<i>FAST TEXAS Workforce Attributes</i>				
Teacher Turnover Rate	14.35	34.61	35.83	40.75
% 1 to 5 Years	25.30	43.75	57.88	58.13
<i>Margin (relative to avg charter)</i>				
Instructional Expense [based on snapshot]				\$4,929,225
Salary Expense [based on FAST TEXAS]				\$10,059,091
http://ritter.tea.state.tx.us/perfreport/snapshot/download.html http://www.fastexas.org/results/downloads.php#district				

Accessing Money by Maintaining Low Cost, Inexperienced Staff

Teachers' salaries and benefits comprise the largest portion of school expenditures, and charter schools recover considerable resources by having markedly lower average salaries (and related benefits). Charter schools generally have teachers concentrated on the lowest end of the scale due to limited experience and lower levels of education. Notably, most charter schools themselves are less than 10 years old, so even staff members there from the beginning could be relatively inexperienced when compared with the broader teacher workforce. Coupled with high rates of teacher turnover, this leads to relatively young teaching staff. Early studies of charter schools in Pennsylvania found charter teacher annual salaries to be on average \$18,000 lower than teacher salaries in district schools. Charter school teacher salaries were also \$11,300 lower than district teachers with similar experience and credentials.⁵³

KIPP and Harmony schools in Texas both rely on very young teaching staff, with inexperience maintained via high turnover, as a primary method for keeping staffing and instructional expenses down, permitting money to be used elsewhere, as for administration in KIPP schools or for facilities in Harmony schools. It is becoming increasingly clear that low cost labor, in the form of young, short term teachers, is a feature and not a bug of the business model of many charter school EMOs. Staff turnover—reduced longevity—also serves to reduce long term health care costs and retirement benefits costs. The percent of teachers with 1 to 5 years of experience in both KIPP and Harmony schools is substantially higher than for “other” charter schools and higher than for urban district schools. For Harmony schools, year over year turnover rate, which helps sustain the *youthful, low paid* teaching staff, is also noticeably higher. A significant body of research validates that this pattern persists nationally.⁵⁴

Where the Money Goes

Spending on High Cost Administrators and Administrative Services

Much has been written in the past about the “administrative blob” in traditional public education. Education reforms, including the push for decentralized “weighted student funding” models, often proclaim that driving “money to the classroom” is a central objective.⁵⁵ Baker and Elmer (2009) explain that empirical studies regarding the efficacy of administrative expenditures are mixed. Studies of charter school administrative and centralized expenses have consistently found charter schools spend far more on central administrative functions than traditional district schools.⁵⁶ To some extent, seemingly elevated administrative expenses in charter schools are a function of apples-to-oranges comparisons. Those expenses may include contracted services like facilities lease payments and/or payments to management organizations. But then again, these expenses may be unnecessary diversions of taxpayer dollars.

Table 4 summarizes management fees of New York City- and Ohio-based EMOs as reported by Baker, Libby & Wiley (2012). In New York City, in 2010, charter schools were typically paying in excess of \$1,000 per pupil in management fees (drawn from operating expenses on the order of \$12,000 to \$15,000 per pupil). Notably, management fees are not total administrative overhead expenses for the schools. Rather, they are fees paid to centralized regional/

national management organizations intended to cover services those organizations provide to schools. What those services entail is difficult to discern.

Table 4. Management Fees per Pupil in Select NYC & OH Charter Schools⁵⁷

EMO	2010	2009	2008
Achievement First	\$ 1,052	\$ 987	\$ 874
Concept (OH)	\$ 806	\$ 607	\$ 561
KIPP NYC	\$ 1,352	\$ 540	\$ 329
Success Academies	\$ 1,232	\$ 1,212	\$ 1,109
Uncommon Schools	\$ 1,343	\$ 1,351	\$ 1,223

While it is possible to obtain salary information for top officials at nonprofit organizations, most for-profit EMOs are privately held and it is not possible to obtain similar salary information. K12 Inc. is a publicly traded for-profit company that operates rather large virtual charter schools. The former CEO of K12 Inc., Ron Packard, was highlighted as one of the highest paid educators in the country. The Center for Media and Democracy reported that Packard made more than \$19 million in compensation between 2009 and 2013,⁵⁸ when only 24% of its virtual schools had acceptable state performance ratings and the company posted a 4-year graduation rate that was half the national average.⁵⁹

As another example of charter administrative expenses, Table 5 shows 2014-15 budgeted expenditures for administration for New Jersey school districts by district type. Again, the administrative expenses include contracted services which may (or may not) include real estate lease-related expenses. Charter school administrative expenses in New Jersey are nearly \$1,000 per pupil higher than those of other regular school district types, and the share of budgets allocated to administration is nearly double.

These averages mask the highest administrative expenses, which occur in Camden Community Charter School (at \$5,325 per pupil, higher than their instructional expense of \$4,225)⁶⁰ and TEAM Academy (a KIPP school, at \$4,851 per pupil,⁶¹ but still much lower than their instructional expense at \$8,639 per pupil).

In New Jersey, local public school districts maintain responsibility for providing some services to charter school students, and thus, the administrative overhead associated with those responsibilities. That is, on a per pupil basis, district administrative expenses are being over-stated and charter school administrative expenses understated in these figures. As explained previously, these publicly reported administrative expenses do not include, for example, expenses (including executive salaries) from regional or national EMOs above and beyond management fees, further potentially understating total administrative expenses of the charter schools.

Table 5. Administrative Overhead for New Jersey Charter Schools and Districts by Type

Operating Type	Mean per Pupil	Percent of Total
K-6 Districts	\$1,603	10.6%
K-8 / 0 – 400 [Very Small Elementary Districts]	\$1,717	10.7%
K-8 / 401 – 750 [Small Elementary Districts]	\$1,687	11.5%
K-8 / 751 + [Large Elementary Districts]	\$1,653	11.1%
K-12 / 0 – 1800 [Small Unified Districts]	\$1,695	11.6%
K-12 / 1801 – 3500 [Mid-sized Unified Districts]	\$1,588	10.8%
K-12 / 3501 + [Large Unified Districts]	\$1,496	10.1%
7-12 / 9-12 [High School/Regional Districts]	\$1,723	10.6%
CHARTER Schools	\$2,654	21.5%
Camden Community Charter School	\$5,325	43.6%
TEAM Academy	\$4,851	31.6%

Data Source: New Jersey Department of Education. Comparative Spending Guide.
<http://www.nj.gov/cgi-bin/education/csg/15/csg.pl>

Table 6 lists the compensation of New York City charter school EMO executives for fiscal year 2011-12 as reported in the *New York Daily News*. At the bottom of the list is the salary for the Chancellor of New York City Public Schools. Other examples around the country reveal similar disconnect between executive compensation for EMO executives and the scope of their enterprise.⁶² These executive salaries far exceed salaries of typical public school district administrators, including administrators of public school districts enrolling much larger numbers of students and with much larger total budgets. In 2011-12, the highest reported public district administrator salary in New York State was around \$405,000; among over 4,000 reported salaries, only five exceeded \$300,000.⁶³

Table 6. Salaries for Leaders of Nonprofit EMOs, Select Charter Schools, and NYC Public Schools

Name	School	Salary
Deborah Kenny	Village Academy Network	\$499,146
Eva Moskowitz	Success Academy CS Inc.	\$475,244
David Levin	KIPP NY	\$395,350
Ian Rowe	Public Prep Network	\$325,002
Dennis McKesey	HCZ Promise Academy	\$285,273
Jeffrey Litt	Icahn Charter Schools	\$280,323
Steven Wilson	Ascend Learning Inc.	\$269,997
Keri Hoyt	Success Academy CS Inc.	\$262,264
David E. Rudall	Uncommon Schools	\$252,941
Christina Tettonis	Hellenic Classical C.S.	\$245,535
Seth Andrew	Democracy Prep Public Schools	\$238,384
Brett Peiser	Uncommon Schools	\$237,782
Douglas McCurry	Achievement First Inc.	\$224,200
Dacia Toll	Achievement First Inc.	\$224,200
Rafiq Kalam Id-Din	Teaching Firms of America	\$219,348
Dennis Walcott	NYC Public Schools	\$212,614

Source: <http://www.nydailynews.com/new-york/education/top-16-nyc-charter-school-execs-out-earn-chancellor-dennis-walcott-article-1.1497717>

Notably, heads of the city’s leading private independent schools (including Horace Mann and Dalton, among others) receive compensation commensurate with these nonprofit EMO/CMO executives.⁶⁴ In many cases, these private independent schools enroll even fewer students than the city’s major charter networks. But, these schools are sustained by privately paid tuition rates, which in 2011-12 typically exceeded \$40,000 per year for day students.

A recent North Carolina Law Review article explores management agreements and fee structures for North Carolina charter operators in greater detail, revealing how observing management fees or executive compensation alone significantly understates financial interests and gains of charter operators and their affiliates.⁶⁵ Kelly (2014) illustrates this by describing the management contracts between for-profit Roger Bacon Academy and several charter schools that it controlled. The contracts entitle RBA to a fee of sixteen percent of total revenues, plus additional incentive payments based on student achievement (p. 1793). Kelly explains:

However, focusing exclusively on management fees significantly understates the amount of money flowing through CDS [Charter Day School] and into RBA’s coffers. Lease payments for real estate are a large source of RBA’s revenue. During the 2013–2014 school year, for example, CDS and Columbus Charter School paid Coastal Habitat Conservancy, an RBA-affiliate controlled by [RBA owner, Baker] Mitchell, approximately \$1.5 million to rent their facilities, plus nearly \$549,000 for maintenance. In addition to leasing its real estate from a Mitchell-controlled company, the schools rent or buy practically everything else they need from either RBA or Coastal Habitat Conservancy: books, furniture, desks, computers, teacher training, and sports equipment. To focus on one sample,

CDS's 2010 Form 990 reported the details of business transactions it entered into with "interested persons," and said that it engaged in six such payments, including a \$1.6 million management fee, \$550,000 for "staff development and supervision," \$170,000 for "back office support," \$965,000 for "building rent – classrooms," \$83,000 for "building rent – admin offices," and \$318,000 for "misc. equipment rental." Based on this evidence, CDS paid insiders (presumably the companies controlled by Mitchell) at least \$3,686,000 in a single year.⁶⁶

Kelley explains that the management contracts of Charter Schools USA and National Heritage Academies in North Carolina contain similar provisions regarding ownership of assets.⁶⁷

Spending Money to Acquire Capital Assets

The above examples illustrate the complexities of tracking resources as they flow among loosely and sometimes more tightly coupled public and private entities. Those examples, which primarily involve redirecting annual operating funds, are among the more straightforward ones to illustrate. Things become much more complex as we delve into the acquisition of capital assets or the buying, selling, and leasing of land and buildings, and the additional parties and financial relationships that are established in this process.

Buying and selling land and constructing and renovating large capital assets inserts new public policy structures. These include debt financing mechanisms used to encourage urban redevelopment, and public policy tools (such as incentives and grants) used to reduce the cost of related debt. These complexities, and the difficulties in untangling them for public consumption, can lead to increased opportunities for unethical, self-enriching activity among various parties. A central lesson of the following section is that the overarching policy structures related to the buying, selling and leasing of school facilities as they intersect with the charter school sector are flawed. The overarching policy structures are ineffective, inequitable and inefficient, even when all parties involved abide by the law and engage in ethical and appropriate behavior.

We begin this section with a primer on municipal bonds and how they work as a tool for financing the debt needed to pay for capital projects (land and buildings) used in educating children. We discuss the technical and practical differences between how local public school districts finance their bond debt versus charter schools and related entities, including how and why charter schools end up paying much higher interest rates on their debt. Next, we discuss how charter operators may rely on either nonprofit entities or for-profit real estate investment trusts to assist them in acquiring properties. We provide some examples of the good, the bad and the ugly among such relationships.

Even in the best cases, the policies designed to enable the acquisition and transfer of major capital assets result in the loss of resources that might otherwise be spent in classrooms. In worse cases, they result in substantial losses and diversion of resources, often difficult to evaluate due to the complexity of financial transactions and relationships among various parties. Perhaps the height of absurdity, a point made in our conclusion of this segment, is the case where a school district facing declining enrollment decides to convert one of its buildings to cash by selling it to an affiliate of a charter operator. In this case, even when parties involved act logically and ethically, public taxpayer dollars are used to buy the same asset twice, and at the end of that second transaction, the public no longer owns the asset.

Municipal Bonds: A Primer

There are significant differences between charter schools and traditional districts in their approaches to gaining access to facilities space. The primary method for facilities access for local public districts is to take on long term (multi-year) debt in order to pay for land acquisition, new construction or renovation (see Figure 9).⁶⁸ Because public budgeting typically operates on a cash accounting basis with limits on roll-over of funds from one year to the next, districts have limited opportunity to incur debt beyond a single fiscal year or to save enough money to cover new major construction costs.

Tax exempt municipal bonds—most often, general obligation, or GO bonds—were created to serve this need (see Figure 9). The basic premise is that a local public school district or municipality may be granted authority to levy property taxes on local residents (and non-resident property owners) to pay off, with interest and over time, the cost of constructing a new facility or any other major capital investment. Project costs are identified, including estimated costs of financing the project. In some states, state aid is provided to offset a portion of construction costs or financing costs.⁶⁹ With such aid, districts or municipalities may take on less debt for a specific project.

In consultation with bond counsel, local boards of education subsequently draft a resolution explaining the project, its purpose, its costs and tax implications. The resolution is then put to a vote (referendum) of the local taxpayers, who are in effect agreeing (or not) to pay the taxes necessary to pay off the principal and interest on the defined timeline. That debt is purchased by financial institutions who bid in public auction on the interest rates and structure of interest payments. The lower the bond rating (higher risk), the higher the interest rates, and vice versa.⁷⁰ GO bonds, guaranteed by the full faith and credit of the taxing jurisdiction, are generally very low risk and thus typically achieve “A” grade ratings resulting in relatively low interest rates on the debt.⁷¹

Financial institutions acquiring the debt then sell bonds to individual investors, who receive tax exempt returns on those bonds. So, the district incurs debt, which the taxpayers agree to pay off. The district pays those tax receipts to the financial institution (or institutions), who in turn pay the bond holders, on a schedule with defined principal and interest payments. The bond holders benefit because while the interest they receive maybe lower than they might have received they had bought equities, the return on their investment is exempt from federal and state taxes.

Revenue Bonds and Charter School Lease Arrangements

Unlike traditional districts, charter schools do not have independent authority to levy taxes. In the absence of an independent taxing authority, charter school operators must either a) use operating funds derived from their public subsidies to make lease payments on facilities owned/leased by others (leasing agent), b) raise cash outside of/above and beyond their public subsidy to apply toward lease payments or to purchase and renovate space, or c) find some other method to incur long term debt to acquire facilities.

Figure 9 depicts a common structure of charter school facilities acquisitions. As with public districts, state law restrictions on expenditure of operating cash often include prohibitions on committing operating cash beyond a single fiscal year, and more specifically, committing operating cash to pay down long term debt beyond a single fiscal year, or sometimes beyond

five years.⁷² The first of these restrictions constrains long-term lease options, and the second constrains capital acquisition. Engaging in year-to-year lease (or up to 5 years) contracts remains most feasible. However, lease contracts dip into operating cash and do not lead to property ownership. In year-to-year leases, the money is spent and is gone.

To pursue the more financially rewarding course of acquiring property, charter operators have engaged several mechanisms for diverting operating cash to property acquisition by using independent, though often closely affiliated, private nonprofit and for-profit entities. These entities, unlike the charter schools themselves, can carry long term debt and thus can access bond markets. While it is difficult to categorize such approaches cleanly, the following two figures present common approaches that charter schools use to finance facilities. The first, in Figure 9, involves access to revenue bonds. Revenue bonds are municipal bonds that, instead of being guaranteed by a dedicated (voter approved) property tax, are to be paid off with some other defined revenue stream. Bond rating agencies generally consider revenue bonds more risky than GO bonds, resulting in higher interest payments.

As noted above, charter schools themselves typically lack the legal authority to guarantee payment of long term debt, so that a charter school board of directors cannot access municipal bond markets.⁷³ Nor can they typically obligate future operating revenue toward the payment of debt for acquiring capital assets, especially over time frames as long as 20 years (well beyond their authorization). One solution to this problem has been for charter school operators to establish separate non-profit entities to carry the debt burden. A separate non-profit entity is established, with its own board of directors, to work with a financial institution to gain access to revenue bonds, which may include Economic Development Bonds targeted for urban renewal projects. The independent non-profit entity takes on the bond debt/obligation to repay investors both principal and interest, and guarantees those bond payments with revenue generated by lease payments from the charter operator. That is, the lease payment is converted into a loan payment toward capital asset acquisition through the third party.⁷⁴

This lease payment, as an operating expense, doesn't need to be approved by local taxpayers. It need only be approved either by the charter school board of directors, or, if embedded in lump sum payment to a management organization, by the private manager. That is, a twice shielded private manager (a private manager hired by a board of private citizens) can choose to obligate current and future charter school operating expenses (derived from public tax dollars, perhaps supplemented with private contributions) to acquire major capital assets. While the apparently independent non-profit, and not the charter school itself, acquires the property, the kinds of relationships among various entities involved in charter networks illustrated above suggests that there is little practical difference in terms of which of the related entities legally benefits from the acquisition.

Capital financing cost reduction options shown in Figure 7 are addressed in a subsequent section.

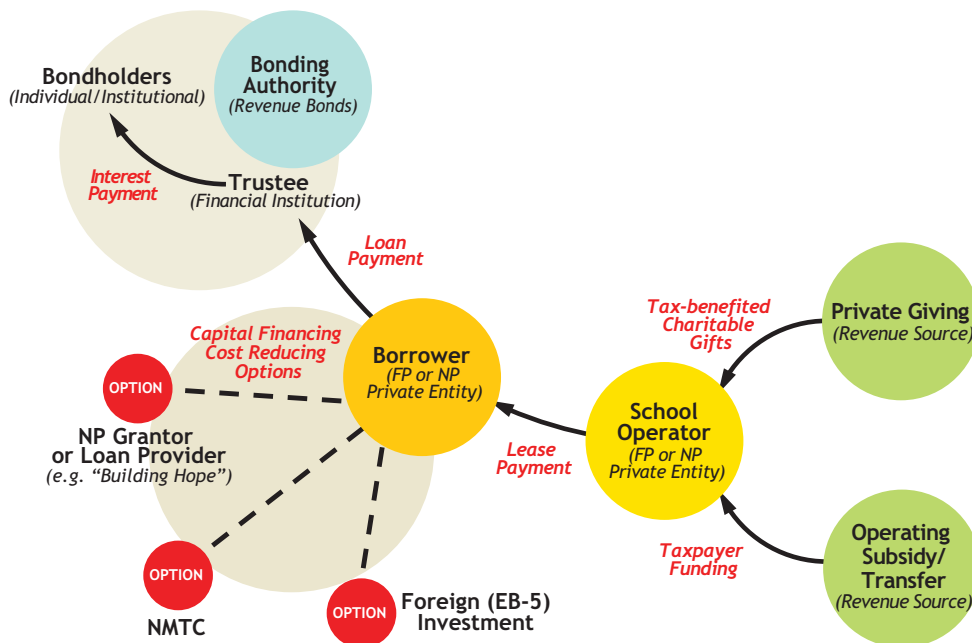


Figure 7. Capital Resource Flow Example #1: Charter School Facility Lease/Acquisition

District versus Charter Schools Debt Service Expense

Figure 10 shows the average interest rates by bond ratings for revenue bonds guaranteed by charter school operating revenues from 1998 to 2014, as reported by The Local Initiatives Support Corporation (LISC, 2014).⁷⁵ The majority of revenue bonds included in the LISC report were rated BBB-, nearly all by Standard & Poors. These bonds typically achieved interest rates of between 5% and 6%. Bonds rated AA during the same period achieved interest rates, on average, a full percentage point lower, which would lead to significantly lower total costs of financing. The only charter school revenue bonds achieving an AA rating were those backed by a secondary guarantor and assigned enhanced ratings.

In contrast to the lower rating and higher interest common to the charter school bond experience, GO bonds for public school districts commonly achieve AA ratings and significantly better interest rates, so that the cost of borrowing tends to be much lower for traditional districts. That is: because charter revenue bonds are guaranteed only or primarily by lease payments from operating revenue, a significant portion of charter operating revenue is being dispersed as interest payments to bond investors. This transaction cost diverts funds that might be more productively spent elsewhere.

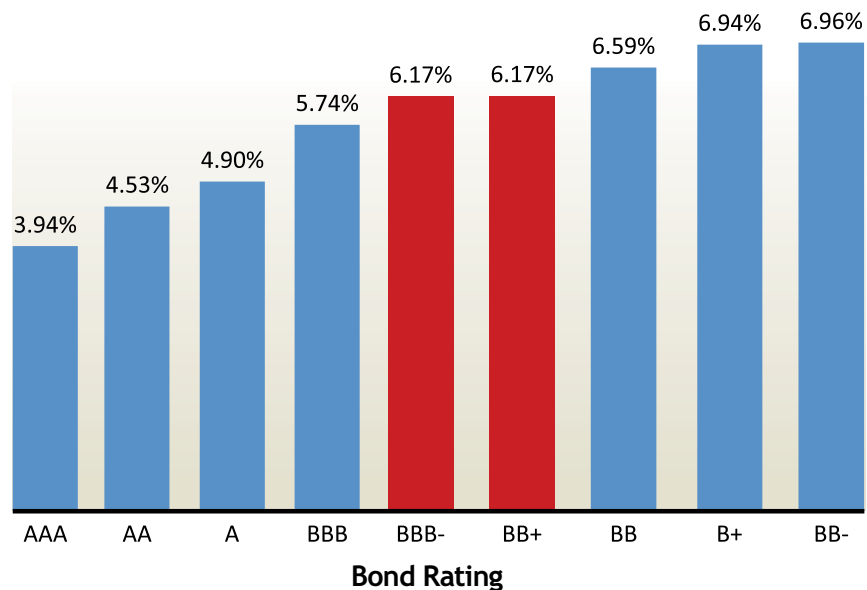


Figure 8. Mean Interest Rates for Charter School Revenue Bonds Issues 1998-2014

Data Source: Charter School Bond Issuance, A Complete History, Vol. 3 [Appendix C]
http://www.lisc.org/docs/resources/effc/bond/2015/2015_Charter_School_Bond_Issuance_v3.pdf

Since 1998, over \$1.2 billion has been financed on BBB- ratings and just under \$1b on BB+ ratings. Over \$4.3 billion has been financed on unrated bonds.⁷⁶

Figure 11 shows that much of the revenue bond debt incurred on behalf of charter schools since 1998 does not mature until after the year 2040. That is, the maturation does not occur until well beyond the authorization renewal period for a typical charter.

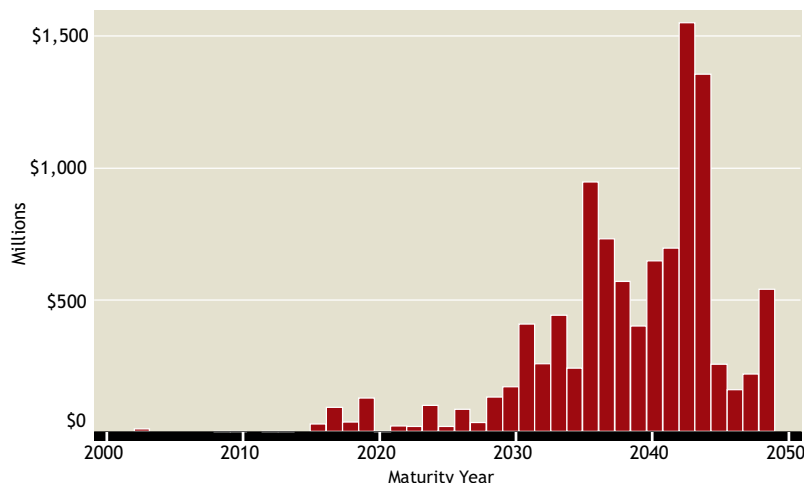


Figure 9. Maturity Dates and Total (initial) Debt for Outstanding Bonds

Data Source: Charter School Bond Issuance, A Complete History, Vol. 3 [Appendix C]
http://www.lisc.org/docs/resources/effc/bond/2015/2015_Charter_School_Bond_Issuance_v3.pdf

An interesting twist is that while charter school enrollments have grown substantially in some cities, and while charter operators have taken on debt that is higher risk and at a higher interest rate, the growth of charter schools in some cities is simultaneously contributing to fiscal stress on host districts and municipalities, resulting in lower bond ratings. That is, charter growth under the current debt financing models is leading to both accumulation of high interest debt for charter operators, and potentially increasing borrowing costs of host districts – a lose/lose deal.⁷⁷

Charter Schools and Real Estate Investment Trusts

Figure 12 below shows an alternative pathway used by many charter schools for access to facilities. Like the previous scenario, this case involves a third-party owner and a leasing agent—a real estate investment trust (REIT). However, while in the previous example the third party was likely to be a non-profit entity, in this case the third party is a for-profit entity. This for-profit entity uses shareholder investments to purchase properties for lease. Shareholders invest on the promise of substantial, predictable returns, including dividends. Promises of returns to shareholders are based on the assurance that tenants will pay a full lease rate at full cost of occupancy—and then some. Further, the tenant (the charter school) is locked into a long-term agreement with scaled up lease payments over time.⁷⁸ That is, these properties have value to investors because they have, in theory, relatively low-risk revenue streams with predictable growth.

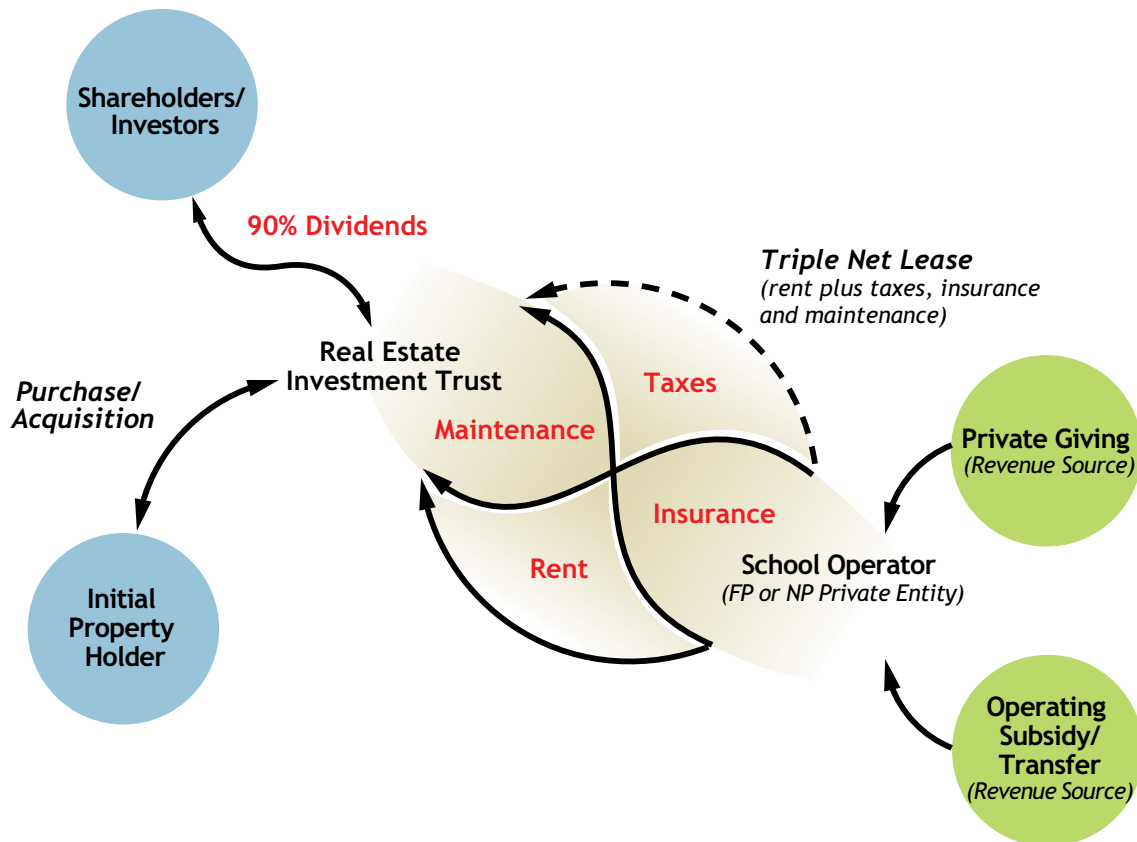


Figure 10. Capital Resource Flow Example #2: Charter School Facility Lease/Acquisition

Lease agreements offered by REITs are commonly “Triple Net Lease”⁷⁹ agreements, which involve the following elements.⁸⁰

- “Single-tenant triple-net agreements lease critical real estate assets to credit-worthy corporate tenants, who then pay, in addition to monthly rent, taxes, insurance and almost all of the facility maintenance costs.
- “The spread between the weighted average cost of capital and the funds generated from the long-term leases is what’s used to pay and generate cash available for distribution to shareholders. Ideally these leases contain some form of regularly scheduled bumps in the rent, either fixed in the lease or tied to an index such as the CPI.”[Consumer Price Index]
 - [In other words, The REIT makes necessary debt payments out of its long-term lease income; income remaining after debt payment is used to fund distributions to shareholders.]
- “In return for not being taxed at the corporate level on earnings, REITs must distribute at least 90 percent of taxable income to shareholders in the form of dividends.”
- “Because, unlike corporations, REITs cannot keep retained earnings at a level adequate to fuel growth, they must return regularly to capital markets—both debt and equity—to fund growth.”

Triple Net Leases through REITs can be particularly costly to schools leasing properties: lease costs that increase over time can put increased pressure on annual operating expenses if revenues do not grow adequately over time as well. In response, legislators in Texas have proposed a constitutional amendment that would exempt properties leased to entities like charter schools from property taxes, which may reduce total costs of leasing for charter operators.⁸¹

Such leasing arrangements are common in the retail and entertainment industries. One of the largest REITs involved in charter school lease agreements, with 63 charter schools around the country, is Entertainment Properties (EPR) of Kansas City, originally focused primarily on properties leased to Kansas City based AMC Theatres.⁸² EPR’s annual reports and investor presentations suggest optimism for continued growth and strong returns from their charter school portfolio.⁸³ Other sources are more skeptical of EPR’s ventures, citing political volatility, stagnant public subsidies and low growth potential as concerns.⁸⁴

Under either arrangement detailed above (that is, lease/acquisition of property through a third-party bond arrangement, or lease/acquisition through a REIT), the acquired property is often originally a traditional public school facility no longer in use. Such facilities start off being owned by the public and paid for with public tax dollars, first through debt financing for land acquisition and construction, and later through ongoing maintenance. The original debt financing of the facility was most likely approved by local taxpayers. In contrast, the sale of the facility to a third party for lease to a charter operator was likely not approved by taxpayers. Nor did voters approve the charter school operator’s use of taxpayer funds (to the extent taxpayer funded operating revenue is required) for purchasing the facility for the third party. In short, what is happening is that taxpayer funds are being used, without voter approval, to purchase a property from the taxpayers themselves, for someone else. The taxpayers are buying the facility a second time, albeit from themselves, but the result is that

these taxpayers will no longer own it. Worse, in the process of transferring the property, taxpayer dollars have subsidized substantial fees and interest to various parties. The icing on the cake is that the federal government has spent federal taxpayer dollars to stimulate these transactions (see LISC, 2014, p. 3-4).⁸⁵

Reducing Capital Financing Costs

Third-party organizations have still other ways to improve their finances. They may reduce their total costs by accessing (a) tax credits dedicated toward urban renewal projects like New Market Tax Credits;⁸⁶ (b) contributions from private foundations dedicated to assisting charter school expansion; (c) low interest loans from private foundations dedicated to assisting charter school expansion; or (d) foreign investment under the EB-5⁸⁷ program which allows foreign investors to trade contributions to certain economic development projects for access to green cards. Under options (b) and (c) above, private foundations may write off their contributions, or in the case of low interest loans, the difference between the interest rate charged and the market rate. In other words, there exists a tax incentive for foundations to contribute to charter school facilities acquisition via either mechanism.

Pushing Ethical and Legal Boundaries with Real Estate Deals & Predatory Leasing

One of the more intriguing options available in the charter sector is the use of current taxpayer dollars to purchase a public asset—like an existing public school—for an affiliated private entity like an REIT, or privately held for profit LLC.⁸⁸ Such arrangements are even more profitable when the asset can be purchased at below-market value. Increasingly, in “recovery-style” state-managed school districts, advocates, close friends or even immediate affiliates of charter operators are being placed in leadership positions in the public schools. That is, those charged with stewardship of the public school district have, as their primary interest, dissolution of the district and expansion of charter schools. These leaders/boards are empowered to approve the transfer of public assets to private hands, often without approval of taxpayers who have vested interest in those assets. With limited taxpayer oversight, selling off public assets at below market value may be common, especially where market values of the unique properties are difficult to estimate.

Previous sections of this brief address the potential for charter schools to pay inappropriate costs for access to facility space. In 2011, the *St. Louis Post Dispatch* revealed the extent of those costs in Imagine Schools operating within the city. Table 7 summarizes the annual rent costs, costs per student, and as a percent of total revenue for Imagine Schools and other St. Louis Charter Schools. Notably, the Imagine Schools’ rent costs are much higher than all others.

Table 7. Annual Rent Costs for Select Missouri Charter Schools

School	Annual rent	Rent Cost per student	Rent as Percent of state revenue
Imagine Academy of Careers *	\$3,138,396	\$2,323.02	20.60%
Imagine Acad. Environmental Science and Math	\$2,449,450	\$1,829.31	16.40%
Imagine Academy of Academic Success	\$709,932	\$1,485.21	14.70%
Confluence College Prep	\$240,910	\$1,033.95	9.80%
Construction Careers Center	\$320,000	\$846.56	8.40%
Confluence South City	\$736,000**	\$812.36	7.70%
St. Louis Charter School	\$714,371	\$782.44	6.70%
Lift for Life	\$383,128***	\$882.78	6.70%
Confluence Walnut Park	\$586,000**	\$639.04	6.10%
Confluence Old North	\$586,000**	\$626.07	6.00%
KIPP Inspire Academy	\$94,600	\$1,139.76	4.00%
St. Louis Language Immersion	\$126,306	\$756.32	3.70%
City Garden Montessori	\$36,000	\$450.00	3.70%
<p>*Imagine Academy of Careers includes three schools: Careers Elementary, Careers Middle and College Preparatory Academy ** Payment goes toward a \$19 million bond used to buy the buildings. *** Payment is a mortgage payment.</p> <p>Sources: Missouri Department of Elementary and Secondary Education, school audits, annual lease agreements, school administrators [from: http://www.stltoday.com/news/local/education/charter-schools-rents-mortgages/article_4df2beb1-1e15-576d-b62b-afa107b260c6.html]</p>			

Imagine Schools have engaged in facilities leasing arrangements detailed in related articles in the *St. Louis Post Dispatch*. The primary strategy involved using an arm of Imagine Schools, Schoolhouse Finance, to acquire properties with the backing of or in collaboration with Entertainment Properties of Kansas City. In many cases, Schoolhouse would acquire the property, invest in necessary improvements and flip the property to EPR [Entertainment Properties of Kansas City, a REIT] (for a profit), which then leased the property back to Schoolhouse, which subleased the property (at 5% to 15% markup) to Imagine Schools. This leads to the much higher than expected lease payments for Imagine schools compared to others accessing facilities space in different ways. Court rulings involving Imagine’s Renaissance Academy in Kansas City, Missouri reveal similar arrangements (discussed in more detail below).

Kelley (2014) explains in his North Carolina Law Review article that charter operators including Charter Schools USA, if not engaging in clearly illegal activity, are engaging in deceitful practices. He explains:

From a nonprofit law perspective, the most troubling aspect of CSUSA’s relationship with its schools involves real estate. CSUSA’s real estate development affiliate, Red Apple Development, owns the North Carolina charter schools’ facilities, and there is at least some evidence to indicate that CSUSA attempted to conceal from state and federal authorities the fact that the schools’ EMO would also, in effect, be their landlord.⁹³

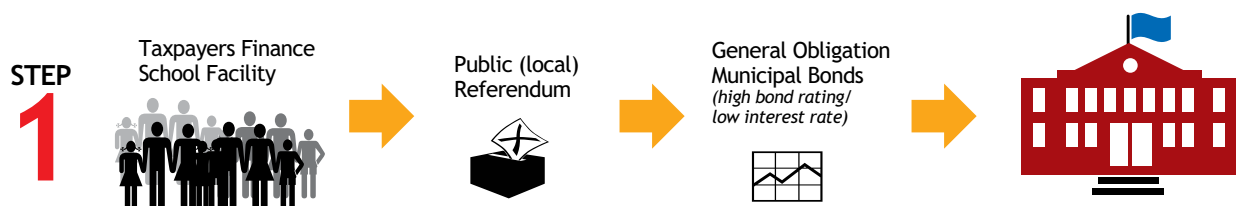
Other Asset Hoarding: The Case of White Hat Management in Ohio

A related example of asset hoarding by private managers took place in Ohio, where state courts recently addressed a dispute between White Hat Management and schools previously contracting White Hat. White Hat's management contracts with the school indicated that White Hat would be owner of any equipment purchased for the school, including desks and computer equipment. When severing their contracts with White Hat, schools were faced with the prospect of having to purchase back from White Hat all of the equipment purchased while White Hat managed the schools. Since this equipment had been purchased with publicly financed operating revenue, the schools challenged White Hat in court over the ownership of the assets. However, the court concurred that the contractual language was clear that the property belonged to White Hat and that the school operators, if they wished to retain that property, would have to purchase it back from White Hat. As explained previously, such provisions in charter operator contracts are not unusual, as found by Kelley (2014) in his review of contracts of North Carolina charter operators. That is, White Hat is not an isolated case.

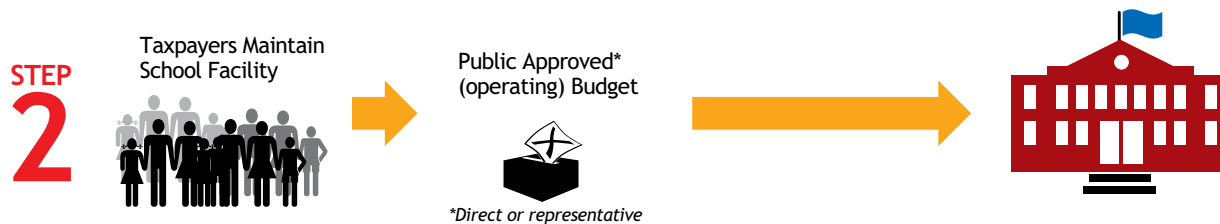
Hypothetical Real Estate Transaction

Here, we provide a walkthrough of how a hypothetical transfer of public assets might occur, starting with the initial public investment in those assets. Our point here is to illustrate the problematic public policy of permitting publicly subsidized charter schools to engage in complex financial arrangements to acquire public assets, while handing them over to private entities at public expense. As noted above, the critique here is of the policy itself; the actions of the individual involved in this scenario make sense. Public districts with excess capital wish to convert that capital to cash. Charter schools needing facilities wish to acquire those facilities through friendly parties rather than being trapped in potentially bad lease arrangements.

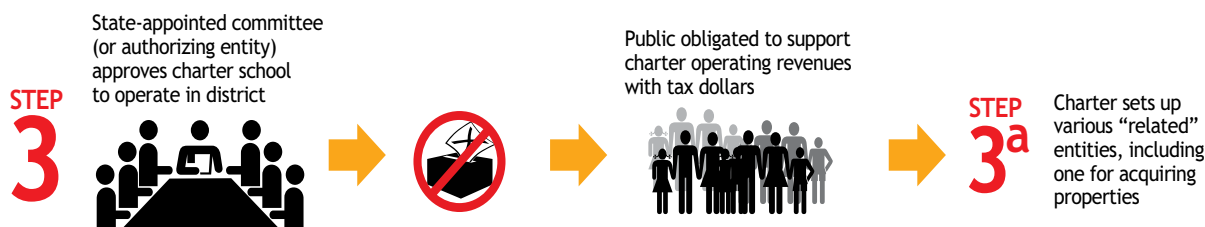
As also noted above, the first step in the process involves local taxpayers (perhaps with a state subsidy) passing a referendum to use low-interest general obligation bonds to construct and fully outfit a school facility.



The “public” then pays taxes to maintain their asset—the school—over time. This might include additional referenda for renovations as well as annual budget approval for maintenance and operation.



Depending on state policy context, a charter school might be established within the geographic space of any given local public school district by an authorizing entity. Sometimes that entity is the district itself, but often it is a different authorizer, such as the state board of education—meaning that the charter is created without approval of the local taxpayers (or state taxpayers) whose tax dollars are then used to subsidize the operations of the charter school. Once the school is established, charter operators may create related entities to engage in real estate transactions on their behalf.



Meanwhile, as charter enrollments increase, and district enrollments drop, the district may desire to reduce costs of capital maintenance and generate some cash. Depending on the state policy context, the district may have authority to liquidate their capital assets (e.g., school buildings) without local board or voter approval. In some cases, state appointees controlling those districts (as in state control, recovery district or emergency manager models) may unilaterally decide to liquidate the assets by selling them to a third party working on behalf of a charter operator.

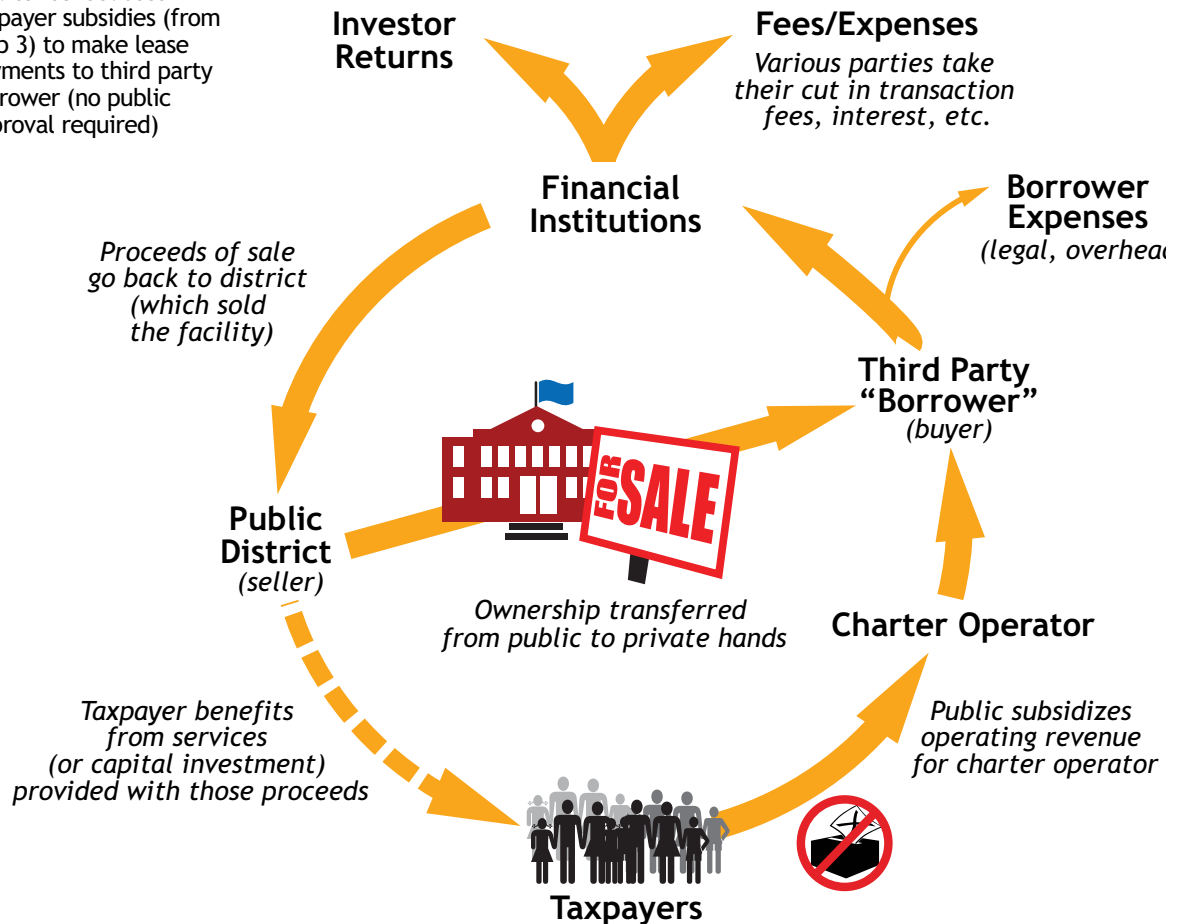


No financial transactions, especially complex transfers of publicly held capital assets, occur without cost. Here, the property is transferred and payment of the debt ensured; but in the process, there are payments of fees, expenses and investor returns. Step 5 illustrates how the taxpayer subsidizes the charter school operating revenue, a (disproportionate) chunk of which is used to make lease payments to the third party. In turn, the third party uses lease payments to reimburse the financial institutions that hold the bonds for investors.

Operating through the third-party borrower results in additional costs. The borrower has legal and financial management expenses associated with these transactions, even if it minimizes management and other overhead costs (for example, by operating only out of a PO Box). Financial institutions extract fees or expenses, and investors are due a return (as noted above, a much higher return than on the General Obligation bonds used to initially construct the facility). In the process, the district does receive payment for the facility, which is a benefit accrued back to the taxpayers who financed it. But in the end what results is a series of unnecessary financial transactions and associated costs—and a public asset transferred to private hands.

STEP 5

Charter school uses taxpayer subsidies (from step 3) to make lease payments to third party borrower (no public approval required)



Threats to Public Accountability

As discussed at the outset of this brief, the increasingly complex, public-private organizational structures of charter schooling create opportunities for opacity in financial reporting and business operations. Some of the financial arrangements and business opportunities discussed above are clearly legally permissible and, for that matter, reasonable in that they allow charter schools and operators to pursue their business interests in arrangements that states and authorizers have determined to be in the public interest. However: other financial arrangements and business opportunities are at best ethically suspect and at worst ethically bankrupt, corrupt and illegal. In other words, legally pursued business interests do not always conflict with public interests. But that which is legal is not necessarily ethical, or in support of the public interest.

Improved transparency is required to ensure that charter schools' financial activities are aligned with the public interest. Potential transparency concerns include:

1. The transfer of large shares—or of all—publicly financed revenues from charter boards to private managers in order to avoid detailed annual expenditure reporting;
2. Less than arm's-length relationships (including overlapping or subsidiary governance) between charter school operators, boards of directors and firms engaging in real estate dealings with or on behalf of charter schools;
3. Less than arm's-length relationships (including overlapping and subsidiary governance) between charter school operators, boards of directors and any/all firms engaging in contractual arrangements with those schools; and
4. Less than independent relationships between charter school authorizers, operators and the management firms they employ.

As discussed earlier in this brief, the basic premise of “chartering” is that an independent state appointed entity—a charter school authorizer—reviews applications for new charters and oversees existing charter schools, including conducting timely, independent reviews for charter renewal. Boards of private citizens apply for those charters, and they may choose to hire private managers to operate their schools, but it is presumed that the boards do not have close ties with those managers. This is not always the case. In the summer of 2014, for example, the *Detroit Free Press* exposed numerous Michigan-based cases in which the independence required for ensuring accountability was severely compromised. Worse, *Free Press* reporters seemed to have great difficulty even accessing documents and relevant financial filings in order to affirm that violations had occurred.⁹⁶

Two other recent cases are illustrative. First, a recent Federal District Court ruling in Kansas City, Missouri exposed significant concerns regarding the relationships among: the board of directors of Renaissance Academy; Imagine Schools—the company contracted to manage the academy; and SchoolHouse Finance, a subsidiary of Imagine that leased facilities to the academy. Second, a state auditor's report from Pennsylvania questioned lease reimbursements paid by Chester Community Charter School. One of the charter school's founders was an individual who previously owned one of the school's leased buildings; the building had been transferred from the school founder to a non-profit entity—controlled by the same founder; and, when that same person established the for-profit management company contracted to manage the school, the building also became home to the new enterprise.

The conflicts of interest associated with the Kansas City Renaissance Academy came to light when the charter school board, years after entering into its original agreement with Imagine Schools, Inc., finally severed ties and filed suit against Imagine for breach of fiduciary duty, unjust enrichment, and racketeering violations. Imagine Schools, Inc. filed a motion for dismissal on the basis that their relationship with the Renaissance Academy board was a mutually agreed upon contractual agreement. To evaluate whether there had in fact been a violation of fiduciary duty, the court laid out the following five stipulations:

1. as between the parties, one must be subservient to the dominant mind and will of the other as a result of age, state of health, illiteracy, mental disability, or ignorance;
2. things of value such as land, monies, a business, or other things of value which are the property of the subservient person must be possessed or managed by the dominant party;
3. there must be a surrender of independence by the subservient party to the dominant party;
4. there must be an automatic or habitual manipulation of the actions of the subservient party by the dominant party; and
5. there must be a showing that the subservient party places a trust and confidence in the dominant party.[pp. 2-3]⁹⁷

The presumption in the chartering model is that the independent board governing the school is the one in charge of hiring (or firing) the private manager. In contrast, the assertion here was that the private manager actually ran the show—was the dominant party—manipulating the governing board. The court found that “All five factors weigh in favor of finding a fiduciary relationship between Renaissance and Imagine Schools.” Further, the court explained:

The Renaissance Board was subservient to Imagine Schools as a result of its inexperience with starting and operating a charter school. [p. 3]

Mr. Curtis Rogers, a highly qualified and experienced public school administrator, would be expected under ordinary circumstances to be a competent and independent board member. Nonetheless, it was his understanding that Imagine Schools had authority over Renaissance Board. He was very competent and very confused. Doctor Carr also gave strong evidence that Imagine Schools was the dominant party vis a vis the Renaissance Board. [pp. 7-8]

Finally, it is not surprising that the Renaissance Board was weak and confused. Imagine Schools recruited the board members, arranged for the board members to apply for the charter and then entered into an Operating Agreement with the Renaissance Board that required the Board to give Imagine Schools all of the tax revenues that the Board was entitled to receive as a charter school. Under Missouri law, Imagine Schools could not obtain that revenue stream itself absent the formation of the Renaissance Board. In short, there is no evidence that Imagine Schools made any effort to recruit an independent board or to strengthen the independence of the Renaissance Board once selected. In fact, it is the policy of

Imagine Schools to control the board rather than vice versa, as evidenced by the statement of Dennis Bakke, the owner and founder of Imagine Schools. Mr. Bakke clearly believed that the Renaissance Academies belonged to Imagine Schools and that the job of the Renaissance Board was to go along with Imagine Schools' decisions unless Imagine Schools was engaging in illegal activity. In fact, Mr. Bakke encouraged his executives to limit and discourage board member control of "Imagine's" charter schools by obtaining pre-signed, undated resignation letters from board members at the time they joined the a board so that board members could be expelled at any time he or she asserted too much authority. It is therefore not a surprise that Mr. Rogers, with all his experience as a public school administrator, did not understand that the Renaissance Board was to give direction to Imagine School and not vice versa. Further in contrast to the status of the Renaissance Board, Imagine Schools is one of the nation's largest charter school management companies and specializes in managing the operations of charter schools.⁹⁸

Among other damages, the court ordered Imagine to pay back to Renaissance amounts overcharged in the lease of facilities from Imagine's own SchoolHouse Finance.

Similar public accountability concerns were raised in a 2013 Pennsylvania Auditors report of Chester Community Charter School. The auditor's report explained:

Our audit found that between June 30, 2008 and June 30, 2011, the Chester Community Charter School (Charter School) improperly received \$1,276,660 in state lease reimbursements for buildings that were ineligible for those payments. We question these buildings' eligibility since one of the Charter School's Founders previously owned them and later transferred them to a related nonprofit (Nonprofit) established for the sole purpose of supporting the Charter School. We also found that the Charter School's Founder was the buildings' landlord until October 2010. Furthermore, this same individual started a for profit Management Company for which he is currently its Chief Executive Officer (CEO). This Management Company runs the Charter School, and the Management Company and the Nonprofit are located at the same address. These ownership transfers and questionable transactions among associated individuals and entities created circular lease arrangements among related parties sharing ownership interest in the buildings. (p. 12)

In October 2010, the Charter School Founder/Management Company CEO sold the buildings to a newly created Nonprofit that he and some associates created with the primary purpose of leasing the properties back to the Charter School. The buildings were sold to the Nonprofit for \$50.7 million and financed through a municipal bond." (p 12-13)

At that time, a new 30 year lease agreement was created between the Charter School and the Nonprofit effective October 9, 2010 to August 31, 2040. According to the Nonprofit's Internal Revenue Service tax returns (2010, 2011, and 2012), all of the Nonprofit's reported income and expenses have been related to the Charter School's leased buildings. (p. 13) ⁹⁹

These are cases where charter operators and individual actors overstepped legal and ethical boundaries. They are also illustrative of risks to public accountability inherent in the increasingly complex structures of governance and financial management in the charter

sector. Both cases came to light only as documents were forcibly obtained either through litigation or by state auditors. Charter schools in other states have challenged state auditors' legal authority to review their finances.¹⁰⁰ Meanwhile, *The Progressive Magazine* reports that charter school fraud has become of sufficient concern to federal investigators to warrant establishing a unit dedicated to investigating complaints.¹⁰¹

Discussion

What makes a school public? The traditional view is that a school is public if it is owned or controlled by citizens or their elected representatives. This *formalist* definition emphasizes institutional arrangements. To determine whether a school is public using this definition requires an assessment of who owns and/or controls how education is provided and to what extent elected bodies oversee schools and their activities.¹⁰² Evidence from Michigan and Ohio suggests that many charter schools come up short on this definition.

Charter school and school choice advocates, by contrast, often argue for a more flexible *functionalist* definition of public. From this perspective, a school is public not by virtue of lines of authority, but by whether it performs important public functions and pursues legislatively defined outcomes. The key questions regarding the functionalist definition revolve not

Over the past few decades, these public-private relationships have become increasingly complex and opaque, and state charter laws have failed to keep pace.

around control and ownership, but around the outcomes produced by the schools. As summarized in the introduction to this brief, among the stated public functions of charter schools are access and equity, new professional opportunities for teachers, student achievement gains, innovation, and customer satisfaction. Here, the record is stronger,

with charter schools doing a reasonably good job of satisfying parents and students that persist; however, the body of research otherwise indicates that charter school results are mixed with respect to outcome expectations and charter schools have, in some contexts, served to accelerate segregation and privatization.¹⁰³

Under both definitions, the purpose of the charter school governing boards is to represent and defend the interests of the public charter school they represent. Although not elected, these are still public boards. Their second key purpose is to represent the interests of taxpayers who fund the public education system.

Charter schooling in the United States has existed for a quarter century. Privatized management of public school operations emerged around that same time. Privately contracted services in education had existed long before that, although it involved only peripheral services and a few short-term and unsuccessful attempts by private companies to take over management of school districts in Baltimore and Hartford, CT.¹⁰⁴ But over the past few decades, these public-private relationships have become increasingly complex and opaque, and state charter laws have failed to keep pace. Most of the business models, financial arrangements, and governing and management structures discussed herein are not inherently "good" or "bad." Nor are they necessarily exclusive to charter schools, as many, such as contracted private for profit management, could be incorporated into traditional public districts or even private schooling.

The types of relationships and models discussed in this brief may be applied in ways that

are (a) both ethical and legal; (b) legal but unethical; or (c) both unethical and illegal. The Renaissance Kansas City case is one in which the federal district court found the behavior of Imagine Schools, Inc. to be illegal, and the behavior of Imagine Schools, Inc. clearly seems unethical as well. On the other hand, it is entirely legal (or at least seems so thus far) for charter operators to collaborate with, or even establish, related entities to assist them in acquiring facilities space. In fact, it makes sense from the charter operator's standpoint. Why not acquire the asset through a friendly entity that is, in return, less likely to later engage in predatory leasing? These practices may make sense, are legal, and may not even raise ethical issues for many people—but that does not make them good public policy.

Four major public policy concerns emerge from the discussion above.

1. A substantial share of public expenditure intended for the delivery of direct educational services to children is being extracted inadvertently or intentionally for personal or business financial gain, creating substantial inefficiencies;
2. Public assets are being unnecessarily transferred to private hands, at public expense, risking the future provision of “public” education;
3. Charter school operators are growing highly endogenous, self-serving private entities built on funds derived from lucrative management fees and rent extraction which further compromise the future provision of “public” education; and
4. Current disclosure requirements make it unlikely that any related legal violations, ethical concerns, or merely bad policies and practices are not realized until clever and difficult investigative reporting, whistleblowers or litigation brings them to light.

First and foremost, we identified far more than we ever expected in terms of ways in which rents are being extracted from public education revenues through charter schooling business models. Some are inadvertent. Some are entirely intentional. Most can be mitigated at least partially by good public policy. Among the inadvertent rent extractions is the interest paid on revenue bonds for charter schools. We suspect most charter operators and their third-party landholders and leasing agents would prefer better bond ratings and interest rates. But the currently available facilities financing mechanisms do not afford them that opportunity. A past practice has been to use federal grants to offset these costs—but that provides a public subsidy to the financial industry and investors.

Potentially redundant and exorbitant central administrative expenses appear also to be more self-enriching. That is, actors within the charter schooling system are extracting these rents and intentionally so. Similarly, less than arm's-length leasing agreements and management fees appear to be extracting resources that might otherwise be dedicated to direct services for children.

Second, there has been a significant transfer of public assets to private hands at public expense. There is no conceivable public policy justification for using taxpayer subsidies to buy a facility for the second time, resulting in that facility being transferred to a private entity. Beyond the obvious fiscal absurdity, there also exists the danger that this practice will lead many urban education systems to a point of no return. If at some point policymakers decide that “chartering” has simply become too ineffective or inefficient a method for delivering education, options for reversing course may not be possible if urban districts no longer own the necessary land and facilities, with additional expenses required for furniture, equipment,

and learning materials.

Finally, current public disclosure requirements seem insufficient for keeping the public informed—until it's too late. In a number of cases even charter governing boards' access to information from their own EMOs has been denied.

Policy Recommendations

To address the concerns raised in the previous section as well as other significant concerns, we offer the following policy recommendations.

Recommendation 1: States should include in their charter statutes a broad declaration that charter schools are “public” and that all remaining provisions should be read to ensure that charter school students, parents and taxpayers waive no rights in their choice to attend a charter school or as a citizen whose tax dollars are allocated to a charter school. They should be red to ensure as well that it is the intention of the legislature that charter schools be operated in a manner equally transparent to any “public” school, to ensure public accountability. While many states do use the phrase “public charter schools” in their charter statutes, there remains much deliberation over the ambiguous use of the work “public” in this context. The above clarifications would provide important guidance for judicial analysis. This recommendation is elaborated further in Mead and Green (2012).¹⁰⁵

Recommendation 2: Districts or other local public and government authorities should maintain control over public lands and facilities and should serve as centralized managers and stewards of facilities space to be used by both district and charter schools. Co-location of charter schools in district owned facilities shared by district schools has been a hot-button issue in recent years. But co-location-type policies may ultimately provide the best protection of the public interest and reduction of rent-extraction. First and foremost, it is in the public interest to maintain control over public assets purchased and maintained over time with taxpayer dollars. This is especially true where population-dense urban real estate is at a premium. Maintaining these public assets avoids the point-of-no-return problem. Further, state laws may clarify methods for determining “market rates” for lease, maintenance and operations of facilities owned by districts or municipalities and used by charter operators. This removes the opportunity for predatory leasing agents to extract rents from educational operating expenses.

Recommendation 3: Authorizers should be required to review any large contracts between charter school boards and EMOs or outside firms. Most importantly, the authorizer needs to scrutinize and approve lease agreements and management agreements between charter school boards and private EMOs.

There is a need for more systematic and effective oversight of charter schools, and authorizers need to publicize information on both oversight processes and findings. Policymakers should make oversight of charter schools more transparent to the public by requiring that authorizers publicize such information. This would allow interested parties to ensure that authorizers are performing their important accountability function and maintaining the link between charter schools and the citizenry at large. Moreover, the state should utilize its legal authority to suspend charter authorizers who fail to engage in appropriate oversight activities.

In the past decade, more attention has focused on improving the quality of oversight. Autho-

rizers receive public money from state education agencies or from the charter schools themselves. Given this arrangement and the expectations that authorizers oversee and safeguard public interests, states should consider ways to sanction authorizers. Further, if authorizers neglect their responsibilities and renew charters that are failing, authorizers should be obliged to return public funds received to provide oversight.

Recommendation 4: Financial reporting requirements must be expanded and elaborated to obligate the same degree of precision in revenue and expense reporting for charter schools as for government entities, and to obligate the reporting of EMO revenues and expenses. Further, where states permit multiple authorizers, including private authorizers, states should require full financial disclosure of related authorizing expenses. Management organizations would be permitted to engage in contracts with charter or district schools only if they agreed to provide detailed annual financial reports in accordance with the state's unified chart of accounts. These management companies should also, as a condition of operating within the state, be required to report any/all relevant individual compensation and credentials to state education agencies for inclusion on statewide personnel data management systems.

Recommendation 5: State charter school laws should be revised to ensure that any and all meetings among officials of the school or its authorizing entity must follow public records and meetings laws. Further, all contracts between governing boards and management companies and between management companies and service providers should be publicly available. This includes posting of all employee or bargaining unit (if any) contracts, including any "taxes" imposed on employee wages.

Recommendation 6: On many levels, states should tighten regulations to ensure appropriate degrees of independence among interested parties. All relationships, be they between (i) school administrator and board members or key contractors such as EMOs; (ii) authorizers and school governing boards; (iii) governing boards and management companies; or (iv) management companies and contractors, must pass basic arms-length tests. Sound ideas regarding contracts with EMOs are found in a recently proposed bill in Connecticut.¹⁰⁶

Recommendation 7: States should more closely link public subsidy rates to relevant costs and needs and use fine-grained reporting of those needs and costs. The funding formulas in most states are based on traditional funding models from a time when there was a singular public school system, mobility was limited, and efforts were made to integrate populations of students. With charter schools and other forms of school choice, there is considerably more mobility. Also, with charter schools being funded based on student head count, there are obvious incentives for "gaming the system."

The funding formulas need to be more granular, and policymakers need to tie funding for charter schools to variations in the true cost of educating different groups of students. Current financial incentives favor excluding more-expensive-to-educate students (i.e., students at the high school level and—in most states—students with special educational needs due to disabilities,¹⁰⁷ language issues, or lack of support from home and the community). By linking funding to variations in the programs and services offered and the specific characteristics and needs of the students served, revised funding formulas would give charter schools and the management companies that operate them the economic incentives to better serve these previously underserved populations.

Recommendation 8: When contracting with EMOs, charter school boards should engage in "smart buying," and authorizers should provide guidance and oversight to ensure that

major contracts are in the interests of the public charter school.¹⁰⁸ Good EMO contracts include the following types of provisions:

- At least two competing bids from EMOs;
- Length of contract no more than the length of the charter, and preferably less;
- Contingency plans so that the option of firing the EMO remains viable and realistic;
- Full disclosure of financial information and test scores to citizens, authorizers, and state officials;
- Budgeting for internal and external evaluations of school and EMO performance; and
- Ensuring that contracted EMO has no personal or professional connections with charter school board members.

It seems clear that the financial incentives embedded in state law, combined with the need for most of the companies to make a profit, have led EMO-run schools to operate in ways that are often at odds with the goals of charter school reforms and, ultimately, the public interest.

Limitations and Future Research

Although this brief has outlined general conditions and trends in charter schools, it is important to recognize that there are considerable differences across states and schools. Similarly, public capital for facilities and bonding possibilities varies extensively from state to state and from area to area. Each charter school reform differs from others in small or large ways. The funding mechanisms responsible for resource allocation to charter schools also differ from state to state. Finally, in addition to differences in the regulatory frameworks, states differ considerably in practice and in the manner and extent to which the regulatory framework is enforced. Because of the wide differences in charter schools within and across states, it is important to recognize that generalizations do not usually apply to all charter schools and all state charter school reforms.

Another important limitation is that there has been limited systematic research on the scope, nature, and consequences of privatization via charter schools. While this brief provides an introduction and overview of the nature and scope of privatization, much more research is needed to deepen our understanding of privatization and the extent of profiteering in charter schools; to illuminate the large and small differences among charter schools; and to understand state regulations and oversight practices.

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Regarding Charter Schools USA, Kelley elaborates: "CSUSA takes a flat management fee defined as fifteen percent of total revenues. Also unlike NHA, the contract provides that at least some equipment and materials purchased for the school become the school's property, meaning the school would be left with some education-related equipment if the management contract were terminated." (p. 1812)

Regarding National Heritage Academies, Kelley elaborates: "Notably, practically everything leased or purchased under the contract remains the property of NHA in case the contract is terminated." (p. 1803) "Either party may terminate the management contract upon ninety days' notice. However, as was true with the RBA-managed schools, the contract's "Grinch" provision ensures that the nonprofit organizations would commit institutional suicide if they were to exercise the termination right since practically all school-related property would remain with NHA." (p. 1804)

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- 70 Yinger, J. (2010). Municipal Bond Ratings and Citizens' Rights. *American law and economics review*, 12(1), 1-38.
- 71 For an overview of municipal bond markets, see: <https://www.lincolinst.edu/subcenters/teaching-fiscal-dimensions-of-planning/materials/elmer-bonds.pdf>
- 72 Verstegen, D. A., & Jordan, T. S. (2009). A fifty-state survey of school finance policies and programs: An overview. *Journal of Education Finance*, 213-230.
- 73 That said, a once removed entity, like a non-profit operator of a collection of charter schools in some states, including Florida can serve as a co-borrower on a revenue bond. See as an example, the Preliminary Official Statement for Renaissance Charter Schools as co-borrower with Red Apple Development for bonds issued by the Florida Development Finance Corporation.
- 74 See, for example, this Preliminary Official State for New Jersey Economic Development Bonds, where Kingston Educational Holdings guarantees payment of debt on the NJEDA bonds using revenue provided by TEAM Academy: <http://www.mcelweequinn.com/jobs/26423725>. Kingston's address, along with Ashland School Development (a company created for related transactions on behalf of KIPP/TEAM Academies in Newark) all share office addresses with KIPP/TEAM Newark at 60 Park Place. Kingston Educational Holdings has not, to date, submitted non-profit tax filings (IRS 990) or information on governance (board members and highest compensated employees) to Guidestar.org, or other common aggregators of these data.
- 75 Berry, W. (2015). *Charter School Bond Issuance, A Complete History, Vol. 3. Local Initiatives Support Corporation*. [appendix C] http://www.lisc.org/docs/resources/effc/bond/2015/2015_Charter_School_Bond_Issuance_v3.pdf
- 76 Berry, W. (2015). *Charter School Bond Issuance, A Complete History, Vol. 3. Local Initiatives Support Corporation* [appendix C] http://www.lisc.org/docs/resources/effc/bond/2015/2015_Charter_School_Bond_Issuance_v3.pdf
- 77 Moody's Investor Services (2015, Nov. 10). *US K-12 Public School Districts: Competition Creates 'Downward Spiral' for Vulnerable School Districts*.
- 78 Babcock, M. (2014) 20-year lease passed for Cherokee Charter building. *Cherokee Tribune*. <http://cherokeetribune.com/bookmark/25363369-20-year-lease-passed-for-Cherokee-Charter-building>
- 79 For a discussion of Triple Net vs. Gross Leases, see: Johnson, J. Blenkush, K. (2011) *Leasing Basics for Minnesota Charter Schools*. Berna, Guzy, Steffen, Ltd. <http://www.bgs.com/real-estate-law/leasing-basics-for-minnesota-charter-schools/>

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- 80 Definition of a Triple-Net Lease. *Investopedia*. <http://www.investopedia.com/terms/n/netnetnet.asp>
- 81 Texas SJR 30. <http://www.capitol.state.tx.us/BillLookup/History.aspx?LegSess=84R&Bill=SJR00030>
- 82 See charter schools list at Entertainment Properties website: <http://www.eprkc.com/portfolio-overview/public-charter-schools-list/>
- 83 Popovec, J.D. (2012) Inside EPR's Charter School Investment Play. *National Real Estate Investor*. <http://nreionline.com/reits/inside-epr-s-charter-school-investment-play>
- 84 Pruitt, A.D. (2012) Entertainment REIT in Trouble at School. *Wall Street Journal*. <http://www.wsj.com/articles/SB10001424052702304458604577490651788595174>
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- 88 For example, Renaissance Charter Schools in Florida, managed by Charter Schools USA, co-borrow with Red Apple Development, and LLC. Renaissance guarantees lease payments, but Red Apple is the eventual owner of the property. See as an example, the Preliminary Official Statement for Renaissance Charter Schools as co-borrower with Red Apple Development for bonds issued by the Florida Development Finance Corporation.
- 89 Crouch, E. (2011). Imagine Schools' real estate deals fuel company growth. *St. Louis Post Dispatch* http://www.stltoday.com/news/local/education/imagine-schools-real-estate-deals-fuel-company-growth/article_dbf9b959-0c73-586c-97e7-6fca3a729b39.html
- 90 See Imagine Schools website: <http://www.imagineschools.com/about-us/schoolhouse-finance/>
- 91 Crouch, E. (2011) Imagine Schools' real estate deals fuel company growth. *St. Louis Post Dispatch*. http://www.stltoday.com/news/local/education/imagine-schools-real-estate-deals-fuel-company-growth/article_dbf9b959-0c73-586c-97e7-6fca3a729b39.html

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- 92 Renaissance Academy for Math and Science of Missouri, Inc. v. Imagine Schools, Inc. (2014). <http://docs.justia.com/cases/federal/district-courts/missouri/mowdce/4:2013cv00645/110158/95>
- 93 Kelley III, T. A. (2014). North Carolina Charter Schools'(Non-) Compliance with State and Federal Nonprofit Law. NCL Rev., 93, 1757 (p. 1813). He later (p. 1814) explains:

... in Cabarrus Charter Academy's charter application to the North Carolina Office of Charter Schools, it responded to a question about school facilities by claiming that a "private developer" would construct the buildings and that the name of the landlord was unknown. Worse yet, the North Carolina charter application filed by Cardinal Charter Academy explicitly claimed that the facility would not be owned by the management company and that it would be constructed and financed by a "third party" who would rent it to the school. It further asserted that the lease agreement would be "independent of the Board's management agreement." These responses are at best disingenuous, since the questions clearly are intended to ferret out whether the management company is also going to be the landlord, and that all of CSUSA's charter-related real estate transactions followed an established pattern that result in its affiliate, Red Apple, leasing the properties to the schools, and reaping what appears to be very healthy returns.
- 94 See: Ohio Supreme Court justices deliver blistering attack on charter schools, White Hat Management. (2015). <http://www.ohio.com/news/break-news/ohio-supreme-court-justices-deliver-blistering-attack-on-charter-schools-white-hat-management-1.624356>
- 95 Kelley III, T. A. (2014). North Carolina Charter Schools'(Non-) Compliance with State and Federal Nonprofit Law. NCL Rev., 93, 1757.
- 96 Detroit Free Press Special Series. (2014). State of Charter Schools: How Michigan spends \$1 billion but fails to hold schools accountable. <http://www.freep.com/article/20140622/NEWS06/140507009/State-of-charter-schools-How-Michigan-spends-1-billion-but-fails-to-hold-schools-accountable>
- 97 Renaissance Academy for Math and Science of Missouri, Inc. v. Imagine Schools, Inc. (2014). <http://courtweb.pamd.uscourts.gov/courtwebsearch/mowd/YgEGzNViWt.pdf>
- 98 Renaissance Academy for Math and Science of Missouri, Inc. v. Imagine Schools, Inc. (2014). <http://courtweb.pamd.uscourts.gov/courtwebsearch/mowd/YgEGzNViWt.pdf>
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- 106 Cohen, R. (2015) Charter Schools Need Basic Standards of Disclosure and Accountability. *Non Profit Quarterly*. <https://nonprofitquarterly.org/policysocial-context/26226-charter-schools-need-practice-basic-standards-of-disclosure-and-accountability.html#.VW8uE9pHmbE.twitter>
- 107 Contrary to most other states where special education is not fully funded, Pennsylvania's approach to financing special education permits charter schools to enhance revenue by gaming the special education populations they serve.
- 108 This recommendation is adapted from Miron, G., & Nelson, C. (2002). *What's public about charter schools? Lessons learned about choice and accountability*. Thousand Oaks, CA: Corwin Press.
- 109 This sentence originally incorrectly stated that for-profit EMOs dominate the charter school sector in New York State.