

Date of Hearing: May 13, 2015

ASSEMBLY COMMITTEE ON EDUCATION
Patrick O'Donnell, Chair
AB 1048 (Baker) – As Introduced February 26, 2015

SUBJECT: School finance: school districts: annual budgets: reserve balance

SUMMARY: Repeals the statutory cap on school district budget reserves and related statutory provisions that are applied in a fiscal year following the fiscal year in which funds are transferred into the Public School System Stabilization Account (PSSSA).

EXISTING LAW:

- 1) Establishes the PSSSA at the state level to be funded by a transfer of capital gains-related tax revenues in excess of 8 percent of general fund revenues.
- 2) Specifies that funds will be appropriated from the PSSSA to schools and community colleges when state support for K-14 education exceeds the allocation of general fund revenues, allocated property taxes and other available resources.
- 3) Requires school districts to maintain the following minimum reserves for economic uncertainties, as a percentage of total expenditures:
 - a) The greater of 5% or \$64,000 for districts with 0 to 300 average daily attendance (ADA);
 - b) The greater of 4% or \$64,000 for districts with 301 to 1,000 ADA;
 - c) 3% for districts with 1,001 to 30,000 ADA;
 - d) 2% for districts with 30,001 to 400,000 ADA; and
 - e) 1% for districts with 400,001 and over ADA.
- 4) Limits the amount that districts may set aside in an assigned or unassigned reserve in the fiscal year following the fiscal year in which a transfer is made to the PSSA as follows:
 - a) For school districts with 400,000 or fewer ADA, the minimum reserve multiplied by 2;
and
 - b) For school districts with more than 400,000 ADA, the minimum reserve multiplied by 3.
- 5) Authorizes a county superintendent of schools to grant a school district under its jurisdiction an exemption from the reserve cap for up to two consecutive fiscal years within a three-year period if the school district provides documentation indicating that extraordinary fiscal circumstances, including, but not limited to, multiyear infrastructure or technology projects, substantiate the need for a combined assigned or unassigned ending fund balance that is in excess of the minimum reserve.
- 6) Requires a school district, as a condition of receiving an exemption to do all of the following:

- a) Provide a statement that substantiates the need for an assigned and unassigned ending fund balance that is in excess of the minimum;
- b) Identify the funding amounts in its budget that are associated with the extraordinary fiscal circumstances; and
- c) Provide documentation that no other fiscal resources are available to fund the extraordinary fiscal circumstances.

FISCAL EFFECT: Unknown

COMMENTS: Existing law requires districts to maintain a minimum reserve, specified as a percentage of total expenditures, but does not impose a cap on reserves except in the year following a transfer to the PSSSA, also referred to as the Proposition 98 reserve account. As a consequence of no cap, some districts have accumulated very large reserves, mounting to 50% or more of total expenditures. Some have noted that this violates a basic tenet of public finance, which is that today's tax revenues should be used to support programs and services for today's taxpayers. The cap on reserves in specified years was enacted in part to prevent the accumulation of unreasonably large reserves and in part to recognize that the transfer of funds into the state-level Proposition 98 reserve reduces the need for large local reserves. This is because the state-level reserve will be used to help maintain K-14 funding during economic downturns, a purpose also served by the local reserves for economic uncertainty.

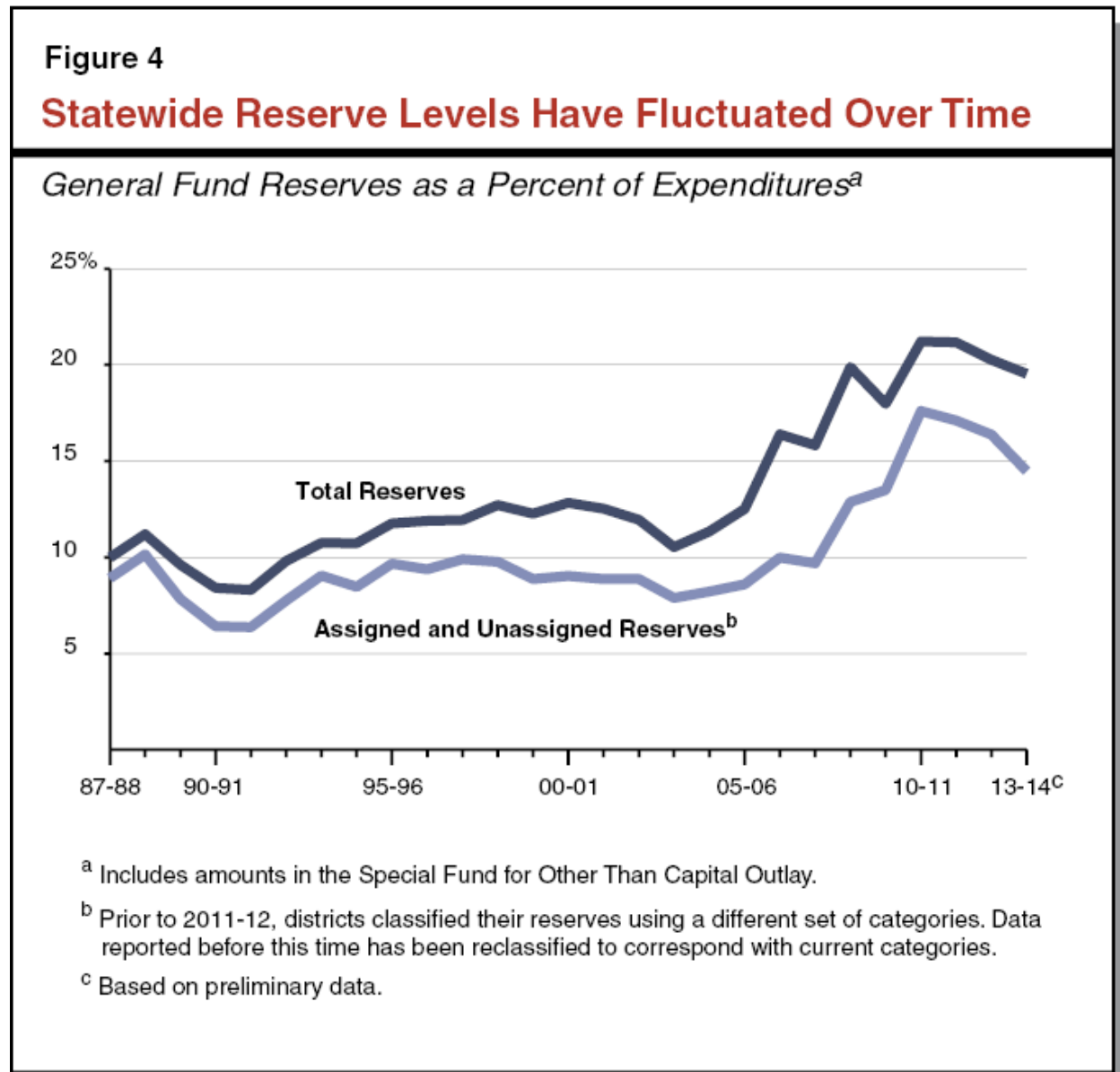
LAO report. The Legislative Analyst's Office (LAO) issued an "Analysis of School District Reserves" in January 2015. The report notes that there are five components to a district's General Fund reserve:

Components of a School District's General Fund Reserve

<i>Component</i>	<i>Description</i>	<i>Example</i>
Non-spendable monies	Amount that is unavailable for spending	A donation toward a permanent endowment that does not allow the principal to be spent.
Restricted monies	Amount that can legally be spent only for specific purposes	An unspent state grant for serving students with disabilities
Committed monies	Amount that has been designated for specific future uses by the school board	Funds set aside by the school board to paint a building next year
Assigned monies	Amount that can has been designated for specific future uses by a district employee	Funds set aside by the superintendent to replace computers next year.
Unassigned monies	Amount that has not been designated for any specific use	Funds not designated for any specific future use

The LAO reports that, statewide, about \$9.8 billion was set aside in these five components in 2013-14. About half of this, or about \$4.8 billion (roughly \$765 per student), was in unassigned reserves. Committed reserves, which require an action of the governing board and are not subject to the cap, accounted for about \$300,000, while assigned reserves, which do not require governing board action, accounted for \$2.5 billion—more than 8 times the amount in committed reserves. The cap applies only to assigned and unassigned reserves. Assigned and unassigned reserves equaled about 15% of total expenditures, on average.

The following figure from the LAO report shows that the amounts in assigned and unassigned reserves increased from 2003-04 to 2010-11, but have begun to decline since 2010-11.



The LAO suggests several reasons for this increase in reserve levels, including:

- Several large infusions of one-time state and federal funding between 2005-06 and 2013-14;
- Potential funding reductions that did not materialize;
- Pessimism regarding the state economy and state budget; and
- Concerns regarding cash and payment deferrals.

The LAO report states, "As a result of [these] one-time state and federal actions, as well as local pessimism and caution, many districts have built higher reserves than they have traditionally maintained. In a more stable budget environment, however, districts seem less likely to view reserves of this level as essential."

The budget cap is not currently in effect. The school district budget cap has not been imposed and will not be imposed until after the state transfers money into the PSSSA, otherwise known as the Proposition 98 reserve account. The purpose of the Proposition 98 reserve is to protect schools against reductions or slow-downs in state General Fund revenue, which would otherwise result in reductions in school funding. This is the same primary purpose as local unassigned reserves. The availability of a state level hedge against economic downturns reduces the need for a local reserve that serves the same purpose.

Options to respond to the cap. Although opponents of the cap have argued that it would "force" districts to slash reserves and increase risk, there are multiple options available to districts to avoid this outcome. First, districts can obtain an exemption from the county superintendent of schools. The exemption is available for two consecutive years within a three year period. To obtain an exemption, districts need to document that its financial circumstances justify a higher level of assigned and unassigned reserves.

Second, districts could assign more monies to their committed reserves. Related legislation, AB 531 (O'Donnell), which passed the Assembly Education Committee on a 6-0 vote, clarifies that committed reserves are exempt from the cap. Using a committed reserve has other benefits:

- A committed reserve requires an action of the governing board, enhancing the board's fiduciary role.
- Because it requires board action, using a committed reserve increases transparency, enabling the public to see how much money is being reserved and for what purpose(s).
- Using the committed reserve does not result in any loss of flexibility, because the governing board can vote to redirect funds in a committed reserve to an alternative purpose at any time.

Third, as noted by the LAO, districts could shift monies from the General Fund to nearly any of the other 29 accounts they maintain. Funds could be transferred back to the General Fund in future years.

Related legislation. AB 531 (O'Donnell) clarifies that funds set aside in a committed reserve are not subject to the cap. AB 1318 (Gray) changes the cap to unspecified levels.

Arguments in support. Supporters argue that the cap is in "direct conflict" with the principle of local control that underlies the local control funding formula. In addition, the cap may have a negative impact on a school district's credit rating and would undermine a district's ability to save

funds "for such things as school construction, school repair, self-insurance, post-employment benefits for employees, investments in education programs including textbooks and technology, and larger purchases such as school buses."

Arguments in opposition. Opponents argue that large reserves were not used to compensate for revenue losses during the recent economic downturn. In fact, reserves increased at the same time districts were making a "significant number of program cuts that impacted students, such as larger class sizes, and shortening the school year, which equated to less instructional time for our students." In addition, opponents argue that the funding of a state-level Proposition 98 reserve will reduce the need for local reserves to provide a buffer against potential revenue reductions.

REGISTERED SUPPORT / OPPOSITION:

Support

Association of California School Administrators
Cal Tax
California Association of School Business Officials
California School Boards Association
California State PTA
Children Now
Educate Our State
Education Trust-West
EdVoice
Kern County Superintendent of Schools
Kings Canyon Unified School District
Public Advocates
San Francisco Unified School District
San Joaquin Office of Education
San Ramon Unified School District
School Employers Association of California
Small School Districts' Association
Numerous individuals

Opposition

American Federation of State, County and Municipal Employees, AFL-CIO
California Labor Federation
California School Employees Association
California Teachers Association
Labor Coalition

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