

Date of Hearing: July 12, 2017

ASSEMBLY COMMITTEE ON EDUCATION

Patrick O'Donnell, Chair

SB 751 (Hill) – As Amended May 2, 2017

SENATE VOTE: 38-0

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

SUMMARY: Modifies provisions related to the local school district budget reserve cap, which is applied in specified years, commencing with the 2018-19 fiscal year. Specifically, **this bill:**

- 1) Raises the cap from two times the minimum reserve requirement (6% for most districts) to 17% for all districts.
- 2) Narrows the application of the cap from the combined assigned and unassigned balances to only the unassigned balances.
- 3) Repeals the requirement that the cap applies to revised, as well as to adopted budgets.
- 4) Clarifies that the cap applies to the ending balances in a district's general fund and special reserve fund for other than capital outlay projects.
- 5) Makes the following changes to the requirement that a governing board hold a public hearing on a proposed budget that has ending balances in excess of the minimum recommended reserve for economic uncertainties:
 - a) Narrows the application of this requirement from the combined assigned and unassigned ending balance to only the unassigned ending balance; and
 - b) Requires the public hearing to include a statement of reasons that explain the unassigned ending balances in excess of the minimum recommended reserve instead of a statement of reasons that substantiates the needs for an ending balance in excess of the minimum recommended reserve.
- 6) Requires, instead of authorizes, county superintendents of schools to grant a waiver of the cap for up to two consecutive fiscal years in a three year period if the school district provides documentation that substantiates the need.
- 7) Repeals the requirement that a district do all of the following in order to receive a waiver from the cap:
 - a) Provide a statement that substantiates the need for an assigned and unassigned ending fund balance that is in excess of the minimum recommended reserve for economic uncertainties;
 - b) Identify the funding amounts in the budget adopted by the school district 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.
- 8) Exempts basic aid districts and districts with fewer than 2,501 average daily attendance (ADA) from the cap.

EXISTING LAW:

- 1) Establishes the Public School System Stabilization Account (PSSSA) at the state level to be funded by a transfer of capital gains-related tax revenues in excess of 8% of general fund revenues whenever **all** of the following conditions occur:
 - a) Revenue from capital gains-related taxes exceed 8% of total General Fund revenue;
 - b) Proposition 98 is in a Test 1 year and is not suspended;
 - c) Proposition 98 funding has been increased for enrollment growth and a cost-of-living adjustment (COLA); and
 - d) A Maintenance Factor is not being accrued.
- 2) Provides that the maximum transfer into the PSSSA shall be the difference between the Proposition 98 Test 1 and Test 2 funding levels.
- 3) Specifies that funds will be appropriated from the PSSSA to schools and community colleges when the amount required to support K-14 education growth and COLA exceeds the allocation of general fund revenues, allocated property taxes and other available resources.
- 4) 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.
- 5) Limits the amount that districts may set aside in combined assigned or unassigned reserves in the fiscal year following the fiscal year in which a transfer is made to the PSSSA 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.
- 6) 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.

- 7) 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: According to the Senate Appropriations Committee: "The bill's modifications to school district reserve caps are unlikely to result in any increase in state costs. At the local level, to the extent that the reserve caps are triggered, the measure could enable school districts to maintain higher or more adequate reserve levels, particularly for basic aid and small school districts. By requiring county offices of education to grant school district exemption requests, there could be potential unknown Proposition 98 General Fund cost pressure for the state to provide additional resources for this new workload."

COMMENTS:

The cap on school district ending balances, to be applied in specified years, was established by SB 858 (Chapter 32, Statutes of 2014) and made contingent on voter approval of Proposition 2 at the 2014 general election. The cap has never been in effect, and neither the Legislative Analyst's Office (LAO) nor the Department of Finance (DOF) forecast that it will take effect in the foreseeable future.

The cap applies to two of three school district reserves. Existing law requires districts to maintain a minimum reserve for economic uncertainties, 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. A 2015 report by the Legislative Analyst's Office (LAO) identifies three different reserves over which school districts have control:

- **Committed reserve**, which is an amount that can be used for any purpose, but has been designated for specific future uses by the governing board;
- **Assigned reserve**, which is an amount that can be used for any purpose, but has been designated for specific uses by a district employee; and
- **Unassigned reserve**, which is amount that can be used for any purpose and has not been designated for any specific future use (this is generally regarded as the reserve for economic uncertainties).

The cap applies only to the combined assigned and unassigned reserves, and not to the committed reserve. The only difference between assigned and committed reserves is that using

the committed reserve requires an action of the governing board, whereas using the assigned reserve does not. Accordingly, even in years in which the reserve cap may be in effect, there is no limit on the amount that may be applied to the committed reserve, as long as it reflects a governing board action, as opposed to the action of a district employee.

Reason for the cap. According to the California Teachers Association (CTA), which supported enactment of the cap, it is necessary to ensure that, to the maximum extent possible, today's school revenues are used to support programs and services for today's students. CTA argues that during the last recession many districts increased the sizes of their reserves instead of using them to maintain or minimize the reduction of programs and services to students. They also argue that the existence of the PSSSA, which is essentially a statewide Proposition 98 rainy day fund, eliminates the need for large local reserves, because funds will be transferred from the PSSSA to local districts when Proposition 98 funding is not sufficient to support existing programs and services.

Concerns have been raised about the cap on reserves. Many in the education community have raised concerns about the cap on school district budget reserves. The concerns focus on two primary issues. First, opponents of the cap argue that it prevents districts from setting aside prudent reserves to guard against an economic downturn and a reduction in state funding for schools. The minimum requirement to guard against such an event is 3% of total expenditures for most districts. The cap is twice that amount, or 6% of total expenditures for most districts. Supporters of the cap argue that 6% is sufficient protection, because (1) it is applied only in a year following a year in which funds are deposited in the state Proposition 98 reserve, and (2) the state reserve serves the same purpose as the local reserve—to provide a cushion against a reduction of revenue to schools. Hence, the state reserve reduces the need for large local reserves for this same purpose.

The second concern is that the cap prevents districts from setting aside monies for a specific purpose in future years. For example, districts may need to accumulate monies over two or more years to purchase technology, instructional materials, or future pension obligations. While it is true that the cap would limit the amount that districts can set aside in an *assigned* reserve for any of these purposes, it *does not limit* the amount that districts can set aside in *committed* reserves for these same purposes.

This bill effectively repeals the cap. Although **this bill** raises the reserve cap to 17% for all districts, it contains two other provisions that have the practical effect of repealing the cap entirely. First, whereas existing law applies the cap to unassigned and assigned reserves, this bill applies it to only unassigned reserves. Accordingly, there would be no limit on the amount that could be shifted from an unassigned to an assigned reserve by a district employee (that is, with no action by the governing board) in order to keep the unassigned reserve within the limit. In other words, any amount in an unassigned reserve that is in excess of the cap could be administratively transferred to an assigned reserve, keeping the district in compliance with the cap without changing the total amount being held in reserve.

Second, whereas existing law applies the cap to adopted and revised budgets, this bill applies it only to adopted budgets. Existing law requires school districts to adopt their budget on or before July 1 of each year. Because this coincides with the adoption of the state budget, the budgets that districts adopt on July 1 are based on incomplete information regarding the state budget and they are always tentative. Therefore, they must be revised at least once during the fiscal year to

reflect the final state budget and other changing circumstances as necessary. Consequently, it is the revised budgets, not the adopted one, that actually govern school district expenditures and the amounts set aside in reserve. By applying the cap only to the adopted budget and not to revised budgets, this bill renders it moot.

Related legislation. Three related bills have been introduced this year:

- AB 235 (O'Donnell), which is pending in the Senate Education Committee, provides that the cap would be in effect only after the amount in the PSSSA reached 3% of prior year state and local Proposition 98 K-12 appropriations. AB 235 also exempts small and basic aid districts from the cap.
- SB 590 (Moorlach) repeals the cap. SB 590 failed passage in the Senate Education Committee.

Prior year legislation includes:

- AB 531 (O'Donnell, 2015), which clarified that the cap does not apply to committed reserves. AB 531 was the subject of a "gut and amend" and died in the Senate Transportation and Housing Committee.
- AB 1048 (Baker, 2015), which repealed the cap. AB 1048 died in the Assembly Appropriations Committee.
- AB 1318 (Gray, 2015), which changed the cap to an unspecified percentage of total expenditures. The hearing on AB 1318 in the Assembly Education Committee was cancelled at the author's request.
- SB 799 (Hill, 2015), which was substantially similar to SB 751. The hearing on SB 799 in the Assembly Education Committee was cancelled at the author's request.

Arguments in support. Supporters argue that the reserve cap is too restrictive, contrary to the goals of the Local Control Funding Formula, and limits the ability of districts to weather fiscal downturns. The existing cap, they state, is "wrong headed" and "serves no positive purpose from either a management or educational perspective."

Arguments in opposition. Opponents argue that the cap is needed to prevent districts from "holding an inordinate amount of funding in reserve," which "inhibits the districts' ability to provide a quality education." Opponents note that the reserves in some districts are more than 10 times the minimum recommended reserves. Holding such large amounts in reserve leads to inequities among districts, with students in some districts "receiving more goods and services than those in other districts."

REGISTERED SUPPORT / OPPOSITION:

Support

Association of California School Administrators
California Association of Suburban School Districts
California Forward Action Fund

California School Boards Association
Compton Unified School District
Fresno Unified School District
Kings Canyon Unified School District
Los Angeles County Office of Education
Public Advocates
Sacramento City Unified School District
School Employers Association of California
Schools for Sound Finance

Opposition

California Teachers Association

Analysis Prepared by: Rick Pratt / ED. / (916) 319-2087