

Date of Hearing: March 15, 2017

ASSEMBLY COMMITTEE ON EDUCATION
Patrick O'Donnell, Chair
AB 235 (O'Donnell) – As Amended March 9, 2017

SUBJECT: School finance: school district annual budgets: reserve balances

SUMMARY: Changes the conditions under which the cap on local school district reserves would be imposed and exempts basic aid districts and small districts from the cap. Specifically, **this bill:**

- 1) Provides that the cap on local school district reserves shall be imposed whenever the level of funding in the Public School System Stabilization Account (PSSSA) equals or exceeds 3% of the prior year total of K-12 Proposition 98 funding.
- 2) Clarifies that the cap applies to the total of assigned and unassigned ending General Fund balances.
- 3) Exempts basic aid districts and small school districts from the cap.

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% 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: Unknown

COMMENTS: The cap on school district reserves (also referred to as 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.

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 argued 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. However, the California School Boards Association (CSBA) and other education management representatives have opposed the cap, arguing that it violates the "principle of subsidiarity" that underlies the Local Control Funding Formula, and presents a hardship to districts by preventing them from building adequate reserves to either make a large, one-time purchase or protect against the next recession. Specifically, opponents of the cap raise the following concerns:

- It prevents districts from saving funds over a period of years to make a large one-time purchase.
- The cap would be in effect whenever a transfer is made into the PSSSA, regardless of the size of the transfer. If only a small amount is transferred, the PSSSA would provide little protection against an economic downturn.
- The cap imposes a unique hardship for small and basic aid districts.

The current cap does not prevent districts from saving dollars over time for a future purchase.

An oft-heard complaint about the reserve cap is that it prevents districts from being able to set aside funds for future use. A common example to illustrate this complaint is that the cap impairs the ability of districts to save funds to pay for rising retirement benefit costs in future years. This is not true.

School districts use assigned and unassigned reserves to set funds aside for potential future use. An unassigned reserve is typically the reserve for economic uncertainty, and its primary purpose is to provide a cushion against unforeseen shortfalls in revenue or increases in expenditures. An assigned reserve contains funds that may be set aside by the district superintendent and designated for a specific future use, such as a large, one-time instructional materials acquisition or future retirement benefits costs. Districts may also use a *committed* reserve to set funds aside for these same purposes, and many do. Committed reserves are **not** subject to the cap, so even when the cap is in effect there is no limit on the amount of funds that can be set aside in a committed reserve.

The only difference between a committed reserve and an assigned reserve is that setting funds aside in a committed reserve requires a vote of the district governing board, whereas using the assigned reserve does not. Although using the committed reserve has been referred to by opponents of the cap as an "end around" the normal budgetary process, it is, in fact, recognized in the California School Accounting Manual and by the Governmental Accounting Standards Board as a standard accounting practice. Using committed reserves instead of assigned reserves to save for a specified future purpose has four advantages:

- **It strengthens the role of the governing board.** Unlike assigned reserves, it takes a vote of the governing board to set aside monies in a committed reserve. This ensures that the elected board members have the primary authority to earmark funds for specific future purposes.
- **It increases transparency.** A board's action to put funds into a committed reserve occurs during a public meeting of the board. This provides the public with the opportunity to review and comment on the proposed future use of those funds.
- **Flexibility is not lost.** Funds in a committed reserve remain flexible. If the governing board decides to redirect funds in a committed reserve to an alternative purpose, it can do so with a majority vote, which provides the same governing board control and transparency as the original vote to put the funds in a committed reserve.
- **It is not subject to the cap.** Even when the cap on assigned and unassigned reserves is in effect, there is no limit to the amount that districts can set aside in a committed reserve.

And as needs change, funds in the committed reserve can be redirected to any other purpose with a vote of the governing board.

Under existing law, the cap would be imposed whenever any transfer is made into the PSSSA, regardless of the amount. The purpose of the PSSSA is to provide a cushion against an economic downturn by having a state-level Proposition 98 "savings account" that can be used to help sustain school funding in low revenue years. This obviates the need to maintain large local reserves for the same purpose. However, concerns have been raised that the cap on local reserves could be triggered by even a small transfer into the PSSSA. In this case, the amount in the PSSSA would be insufficient to sustain school funding.

AB 235 fixes this by changing the trigger. Specifically, instead of imposing the cap in the year after a transfer of any amount is made into the PSSSA, AB 235 imposes the cap only after the amount of monies in the PSSSA equals or exceeds 3% of the prior year state and local Proposition 98 funding for K-12. The 3% threshold matches the minimum reserve requirement for most districts and should provide a reasonable amount of funding in the PSSSA to protect districts against revenue shortfalls.

The cap imposes a unique hardship for small and basic aid districts. The cap affects small and basic aid districts in different ways. Small districts, by definition, have low average daily attendance (ADA), which means they also have small budgets. Applying a 6% or even a 10% cap to these districts would result in reserves that have very small dollar amounts.

The concern with basic aid districts is that they do not receive LCFF funding from the state, because local revenues meet or exceed their LCFF allocations. Presumably, the state would use the LCFF to distribute funds from the PSSSA to local school districts when conditions warrant. Since basic aid districts do not receive LCFF funding, they would not benefit from this distribution mechanism.

AB 235 fixes both of these problems by exempting small and basic aid districts from the cap. According to the LAO, in 2015-16 there were 97 basic aid district and 409 small districts, of which 60 were both, basic aid and small, so this exemption would apply to 446 districts.

Staff recommends technical/clarifying amendments to do the following:

- Require the Superintendent of Public Instruction to notify school districts and county superintendents of schools when the conditions for imposing the cap have been met and when they are no longer in effect.
- Add clarifying language to avoid confusion between references to the state General Fund and school district general funds.
- Clarify the definition of basic aid districts.

REGISTERED SUPPORT / OPPOSITION:

Support

Beverly Hills Unified School District
Bret Harte Union High School District

College School District
Encinitas Union School District
Forestville Union School District
Fremont Union High School District
Goleta Union School District
Horicon Elementary School District
Kenwood School District
Laguna Beach Unified School District
Las Lomas Elementary District
Los Altos School District
McKittrick School District
Montecito Union School District
Mountain View Los Altos High School District
Nevada City School District
Newport-Mesa Unified School District
Rancho Santa Fe School District
San Luis Coastal Unified School District
San Rafael City Schools
Santa Clara Unified School District
Schools for Sound Finance
Shoreline Unified School District
Solano Beach School District
St. Helena Unified School District
Sunnyvale School District
Tamalpais Union High School District
Tahoe Truckee Unified School District

Opposition

None received

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