The FISCAL REPORT an informational update

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2017-18 Statewide Average Reserve Levels Slightly Down

The California Department of Education released the 2017-18 Unaudited Actual data that allow for the calculation of the district type and statewide average reserve levels.

The reserve levels are defined as the unrestricted net ending fund balance for the General Fund, plus the ending balance for Fund 17 (Special Reserve for Other Than Capital Outlay Projects) as a percentage of total General Fund (including restricted programs) expenditures, transfers, and other uses. The averages by district type are as follows:

2017-18 Average Unrestricted General Fund, Plus Fund 17; Net Ending Balances as a Percentage of Total General Fund Expenditures, Transfers, and Other Uses		Change from Prior Year
Unified School Districts	16.98%	-0.27%
Elementary School Districts	20.20%	-0.88%
High School Districts	15.63%	-1.01%

The 2017-18 percentages for both unified and high school districts are below the 17% minimum (two months of payroll) amount of reserves for local governments recommended by the Governmental Finance Officers Association. While the elementary school districts' average is higher, there are many more small elementary school districts, which more than justifies a higher elementary school statewide average, in our opinion.

—John Gray and Dave Heckler

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RESERVE AVERAGES

* CFD AVERAGE: 23.05%
* STATE AID AVERAGE: 17.18%
* STATE AVERAGE: 17.46%

Community Funded Reserves

Over the past three decades, we have often written about the level of reserves needed in community funded districts and why they need to be higher than those of state-funded districts. We periodically update our advice and the rationale for that advice in light of current economic times and the practical considerations necessary to cope with those conditions. Coming out of the longest and deepest recession our state has experienced in our lifetimes and coming through historic school finance reform of the Local Control Funding Formula (LCFF), it is timely to review the factors that go into determining "adequate" reserves for a district operating largely on the receipt of local tax revenues.

While all community funded districts have local resources that sufficiently fund the state-required minimum level of school funding, local financial circumstances vary widely. A long-standing community funded district may have a very stable tax base that puts the district well into community funded status. Another district could be recently into community funded, based on declining enrollment or recent growth in property values, finding themselves bouncing between state-funded and community-funded status. Other districts may have a significant portion of their property tax revenues based on a single industry. All of these unique factors play into the way a community-funded district will approach its reserve levels. For these reasons, we suggest that our rationale for calculating an appropriate level of reserves be regarded as a decision-making guide. All of the factors we consider are of different value to districts in widely diverse positions. We suggest that while you consider each factor, you weigh it according to your own circumstances and professional judgment.

Community Funded Reserves During Good Times

During good times, when state-funded districts get their historical average of about a 4% increase in revenues and community funded districts get their historical average of about 6.5% in increased property taxes, our advice to community funded districts is very straightforward. We think that, in addition to the standard 3% reserve for economic uncertainties maintained by all districts, community funded districts need to put aside a separate community funded reserve equal to about one-third of the difference between the district's LCFF funding level and its community funded funding level.

As a state-aid district transitions to community funded, we recommend that in the first year, the district set aside at least one-third of the excess revenues provided by property taxes. So, if the district gets $3 million above its LCFF entitlement funding level, we recommend that the district reserve $1 million and spend no more than $2 million. In the second year, if the district's local revenues grow another $3 million, for a total of $6 million, then $1 million more should be added to the reserve and no more than $5 million would be spent. As you can see, reserves only have to be set aside once and, therefore, funds become available for spending increases each year after the first year.

Districts that have followed our recommendations typically carry at least the standard 3% reserve for economic uncertainties and, in a separate community funded reserve, another 33% of the difference between the funding level guaranteed by the state and estimated local revenues that fund the district. Our reason for recommending the higher reserve is that community funded districts have no protection when property taxes decline until they once again become a state-funded district. State aid districts have some degree of protection because they are funded on the greater of current- or prior-year average daily attendance, and the state backfills losses in local revenue. In contrast, any negative changes in enrollment, expenditures, or property tax revenues are the sole responsibility of the community funded district. We think our recommended policy regarding the level of reserves has served community funded districts well for most of the past three decades.

Community Funded Reserves During Bad Times

As we have seen more recently, during bad times—those when the state is cutting both state general purpose funding and categorical funding, and property taxes are declining as well—we think further discussion of reserves is in order. Specifically, the threats to fiscal stability for community funded districts increase in both number and severity during difficult financial times.

For example, during the recent Great Recession, property taxes went flat or declined in many areas of the state. Additionally, categorical funds received by all districts, including community funded districts, were cut by about 20%. We also saw concerns about renewed state attacks on "excess" property taxes. And, community funded districts paid a "fair-share" cut equal to the per-student amount lost by revenue limit districts; that amount was paid from their remaining state categorical aid allocations.

Enrollment growth, charter schools, districts of choice, and other unique district factors, such as the loss of a major employer or construction slowdown, have also affected the fiscal stability of community funded districts. For many community funded districts, especially those that are newly community funded, the vulnerabilities can seem overwhelming.

As a result, many community funded districts saw their reserves erode at an alarming rate. Some community funded districts faced serious fiscal problems. Especially vulnerable were those newer community funded districts that had experienced substantial declines in property tax revenues, increasing enrollment, creation of charter schools, and other losses of revenue or increased costs. And for community funded as well as all other districts, the delayed payment of categorical funds created cash flow challenges.

Community Funded Reserves During Uncertain Times

As California continues to recover from the worst recession in history, the mechanism for how K-12 education is funded changed dramatically. Under the new LCFF, community funded districts' fair share reduction applied to categorical funds was permanently captured by the state. While the new formula guarantees a minimum state aid funding level based on 2012-13, it won't restore categorical losses experienced by community funded districts during the recession and will not be adjusted for growth. The new formula will be implemented over the next decade, and in the interim school districts—both state funded and community funded—will find themselves in circumstances that may be quite different from their neighbors. Establishing and sustaining a prudent reserve will have you well prepared to face any uncertainties that the future may bring, and will serve you well in both good and bad times.

How Does This Impact Our Advice on Reserves?

First, our recent experience with volatile economic and political conditions and their effect on community funded districts has reinforced our conviction that community funded districts definitely need higher reserves than do state aid districts. And we think that, long term, our 33% guideline remains appropriate. But as we have seen recently, even a very conservative reserve can evaporate quickly. The combined effects of step and column expense, health and welfare benefit cost increases, the "fair-share" contribution, increased costs of special education and other programs, and lost revenue have caused many community funded districts to spend major portions of the reserve just to get through the last few years, not to mention the challenge of meeting the state-required three-year multiyear projection.

Bottom line, we see our recommendation as being the bare minimum, not the more comfortable level we once expected it to be. So now when a district asks us how much they need to have in reserve, our answer is always the same: "More."