School District Fiscal Savings and State Budget Rules

BY THEODORE ARAPIS AND VINCENT REITANO

Fiscal savings have become an integral part of state and local government financial management because they can provide budgetary flexibility during a fiscal crisis. Professional organizations such as the Government Finance Officers Association (GFOA) encourage governments to accumulate and maintain savings as part of their unrestricted fund balance. Some states, however, impose rules that restrict the fiscal savings accumulation of school districts. This article provides an initial exploration of state rules imposed on their fiscal savings and makes policy recommendations for budgeters and elected officials.

BEST PRACTICES IN FISCAL SAVINGS

Since 2002, GFOA has provided clear guidance to state and local governments for fiscal savings accumulation. In fact, in its best practice, *Appropriate Level of Unrestricted Fund Balance in the General Fund* (available at www.gfoa.org), GFOA recommends that general-purpose governments maintain an unrestricted fund balance of no less than two months of regular general fund operating revenues or regular general fund operating expenditures. Governments should also adjust their fiscal savings depending on their unique operational and environmental circumstances. For example, governments that are experiencing revenue volatility or expecting cuts in state and federal aid may need to maintain a higher level of savings. Of course, the same is true for governments facing increased service demand due to population growth, high infrastructure needs, and natural disasters.

From an accounting perspective, the unrestricted fund balance is the sum of the committed, assigned, and unassigned fund balance. Of its three components, the unassigned portion receives the most attention from scholars and practitioners, since it represents a true savings account that can be used for any purpose at the discretion of a government. According to a number of studies, local governments typically follow GFOA's recommendation and maintain an unassigned fund balance of at least two months of operating expenditures. In fact, the GFOA Financial Indicators database indicates that ending balances (equivalent to unassigned fund balance) for the last two decades have never dropped below GFOA's minimum target. Likewise, local government research studies conducted across a variety of states — including Minnesota, Illinois, North Carolina, Mississippi, and Florida[1] — also reach similar conclusions. Evidently, fiscal savings have become "routine for most local governments."[2]

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Governments should not only maintain a minimum level of savings but also form a detailed policy explaining the rationale behind the unrestricted fund balance and its predetermined level, maintenance, and use. Specifically, when establishing a fund balance policy, governments should explicitly define and detail: a) the time period and the contingencies the fund balance may be used for; b) revenue and expenditure adjustments necessary for financially supporting fund balance accumulation; and c) the time period and the financing means used for replenishing the fund balance, according to *Appropriate Level of Unrestricted Fund Balance in the General Fund*. The time horizon for replenishing the fund balance should also be set — generally between one and three years. Revenues used for replenishing the fund balance could include one-time revenues (e.g. user fees and charges), operating budget and year-end surpluses, and residual amounts from other funds (governmental and non-governmental), if legally permissible.

While it is critical to form a policy determining the desired unrestricted fund balance level and its maintenance and use, it is equally important to provide explanations when fiscal savings exceed their predetermined level. Often, governments find themselves holding an excessive amount of unrestricted fund balance that surpasses their formal policy. Such cases may motivate taxpayers and other stakeholders to question a government's policies and its financial management strategies. When governments hold excessive amounts of fund balance, taxpayers could logically question if they are overcharged for services or even if the government delivers less quantity and worse quality services than promised. Therefore, GFOA encourages governments to articulate a policy for the use of unrestricted fund balance beyond the predetermined level.

FISCAL SAVINGS AND STATE RESTRICTIONS

The way special-purpose governments such as school districts establish and use fiscal savings is similar to that of general-purpose governments. Fiscal savings accumulated in the unassigned fund balance can be used to mitigate revenue shortfalls arising from fluctuations in property taxes and state aid, while also covering unexpected expenditures. Therefore, fiscal savings can be an important strategy against tenuous times such as the Great Recession, when the collapse of the real estate market and extensive cutbacks in state aid imposed unprecedented constraints on school district revenues.

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Despite the recognized benefits of fiscal savings, some states impose restrictive rules on the unassigned fund balance and related stabilization funds held by school districts. In fact, two types of rules are sometimes placed on the unassigned fund balance: limits and minimums. Limits are simply a selected level of unassigned fund balance that a school district cannot exceed. Minimums, on the other hand, are the lowest level of unassigned fund balance a school district should constantly maintain.

A nationwide search indicated that only 10 states impose rules on fiscal savings for school districts (see Exhibit 1).[3] Seven states (Alaska, California, Colorado, Georgia, New York, Pennsylvania, and Tennessee) have introduced limits, while three states (Alabama, Delaware, and Kentucky) require minimums. The vast majority of state governments impose no restrictions on school district fiscal savings accumulation (see Exhibit 2).

Interestingly, Exhibits 1 and 2 indicate no clear pattern among state rules for school district savings. States that have imposed limits and minimums do not follow best practices in financial management promulgated by the GFOA and other professional organizations. Instead, it appears that state governments arbitrarily set limits and minimums on their school districts. School districts, therefore, may be unable to save at desired levels and establish a budgetary cushion adequate to sustain services during periods of economic uncertainty and fluctuation.

Recent studies have found that school districts largely ignore state-imposed rules on fiscal savings. For example, consider the case of Pennsylvania and New York. Since the 2005-2006 school year, the Pennsylvania Legislature has forced a sliding scale of limits on the amount of savings (8 to 12 percent of expenditures) that a school district can accumulate in its unassigned fund balance. The limits are linked to a school district's level of expenditures and only enacted if property taxes are raised. An examination of fiscal savings

Exhibit 1: Fiscal Savings Rules by State

State	Limits on Fiscal Savings	Minimums on Fiscal Savings	Description
Alabama		X	At least 1 month of operating expenditures
Alaska	X		No more than 10 percent of operating expenditures
California	X		Limits based on district enrollment
Colorado	X		Save 3 percent of expenditures in emergency reserve
Delaware		X	End-of-year balance should be 1 month of payroll
Georgia	X		Not to exceed 15 percent
Kentucky		X	2 percent minimum of operating expenditures
New York	X		4 percent limit of operating expenditures
Pennsylvania	X		Sliding scale limit (8 to 12 percent of operating expenditures) applied to districts that intend to raise mill rates
Tennessee	X		Dedicated education fund that's more than 3 percent of expenditures

Exhibit 2: Map of State-Imposed Fund Balance Rules on School Districts

among all 500 Pennsylvania school districts found that half of districts ignored the state limitations, since they suffered no penalties for doing so.[4]

In the State of New York, limitations are imposed in accordance to the Real Property Tax Law, which was passed in response to school districts retaining high fund balances.[5] According to this law, until 2007, school districts were only allowed to accumulate fiscal savings up to 2 percent of operating expenditures. Since 2007, an amendment to the law gradually increased the level of unreserved fund balance to 4 percent. However, research found that 65 percent of New York school districts were not following the state minimums.[6] New York, like Pennsylvania, does not impose penalties to school districts that choose not to follow this law.

POLICY RECOMMENDATIONS

State-imposed rules on school district fiscal savings appear to carry a one-size-fits-all design, which fails to conform with professional standards such as GFOA's minimum target recommendation. Rules on school district fiscal savings may be largely political rather than grounded in evidence-based policy. However, not all school districts within a state face the same fiscal, operational, and demographic circumstances. A uniform fiscal savings policy, therefore, may not be appropriate for all school districts within the same state.

Instead, school districts (when legally permissible) should form their own fund balance policies, tailored to fit their own specific needs. A fund balance policy should include the descriptions outlined below.

The Reasons Why Fiscal Savings Are Required. The reasons behind a fund balance policy may include the district's fiscal health and wealth; its revenue portfolio, operation and maintenance costs; enrollment trends; and the composition of its student body. Research on New York school districts noted that "Prudent financial management would suggest that small, poor districts should maintain relatively high balances, because they have the least capacity to weather a fiscal shock."[7] The argument was also supported by the examination of Pennsylvania school districts.

Similarly, districts that depend primarily on discretionary funding sources (e.g., state aid) may need higher fiscal savings than school districts with diversified revenue sources (e.g., property taxes, local sales tax, earned income tax, state aid, federal aid, donations, and contributions) to overcome sudden revenue flow changes. Further, school districts with high concentrations of students living in poverty, with disabilities, or with limited English proficiency face higher-than-average costs.[8] Therefore, such districts will require higher use of fiscal savings to sustain services to such populations. Whether a district operates in a rural or urban area may also affect fiscal savings behavior. A rural district, for instance, is exposed to different levels of risk than an urban district. As a result, a rural district may require a higher level of fiscal savings.

The Methods Used for Accumulating, Maintaining, and Replenishing Fiscal Savings. Recent studies on school district fiscal savings identify property taxes as the most important factor in fiscal savings accumulation.[9] A policy, therefore, could allow school districts to accumulate savings when property taxes exceed forecasts during an economic boom, when real estate markets outperform. Further, given the revenue limitations school districts have faced in the post-recession era, they must make an effort to withhold the growth of their main expenditure categories. A study of Pennsylvania districts found that cutback management has helped the districts restrict the growth in the most important expenditure category, personnel cost.[10] As a result, school districts that implemented cutbacks in personnel cost managed to maintain higher savings. Likewise, districts that have made efficiency gains in student transportation (e.g., redirecting routes) were also able to maintain higher savings. Lastly, avoiding expensive capital projects and sustaining a low debt ratio was also helpful for Pennsylvania school districts in maintaining their fiscal savings.

Rules on the Use of Fiscal Savings. Considering that fiscal savings are limited, school districts should form a specific plan for their use. For example, school districts could allocate fiscal savings based on where spending produces the most benefits for students. Since educating students is the single most important reason for the existence of school districts, it may be prudent to use fiscal savings to support instructional expenses in certain cases (e.g., teacher compensation, equipment, and student nutrition). On the other hand, when revenues are short of expenditures, using fiscal savings for capital projects, facilities maintenance, and vendor repayment should fall to the bottom of the priority list. Still, rules on the use of fiscal savings are largely normative and should be left to a discussion between budgeters, elected officials, and the public, among other stakeholders. These types of discussions among stakeholders can potentially circumvent debate over the appropriate use of fiscal savings, especially from taxpayers who may view them as problematic.

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CONCLUSIONS

Governments at the local level, including school districts, continue to face a precarious situation in the post-recession era. Revenues continue to be constrained due to cuts in state aid and a property market that has yet to fully recover. In response, school districts need to develop formal fund balance policies and start accumulating fiscal savings. If school districts follow this guidance, they should also commit a greater effort to educating taxpayers about their budget challenges as well as the importance of establishing and maintaining fiscal savings. This recommendation is critical to building transparency and trust between school districts and taxpayers. Ultimately, governments such as school districts should include fiscal reserves as part of their long-term financial planning to prepare for the possibility of a crisis.

Notes

1. Justin Marlowe, "Fiscal Slack and Counter-Cyclical Expenditure Stabilization: A First Look at the Local Level," *Public Budgeting & Finance*, 25(3), 2005; Rebecca Hendrick, "The Role of Slack in Local Government Finance," *Public Budgeting & Finance*, 26(1), 2006; Wen Wang and Yilin Hou, "Do Local Governments Save and Spend Across Business Cycles? Evidence from North Carolina," *American Review of Public Administration*, 42(2), 2012; LaShonda Stewart, "Examining Factors that Impact Mississippi Counties' Unreserved Fund Balance during Relative Resource Abundance and Relative Resource Scarcity," *Public Budgeting & Finance*, 29(4), 2009; and Theodore Arapis and Vincent Reitano, "A Glimmer of Optimism in Government Savings Accumulation? An Empirical Examination of Municipal Unassigned Fund Balance in Florida," *Public Finance Review*, 2016 (advanced online access at http://journals.sagepub.com/doi/full/10.1177/1091142116643386).
2. Theodore Arapis and Vincent Reitano, "Accumulating and Maintaining Fiscal Savings: From Theory to Practice, " *Journal of Government Financial Management*," Spring 2017.
3. The authors consulted state-level education agency websites and policy guidance, news articles, and school district comprehensive annual financial reports for the existence of state-imposed rules. Citations for all rules are included in Exhibit 1.
4. Theodore Arapis, Earl Bruck, and Vincent Reitano, "The Fiscal Savings Behavior of Pennsylvania School Districts Through the Great Recession," *Public Budgeting & Finance*, forthcoming.
5. Istavan Vanyolos, "The Impact of State-Imposed Fund Balance Limits on School Districts: Evidence from New York State," *Journal of Public Accounting, Budgeting and Financial Management*, 23(2), 2011.
6. Vanyolos.
7. William Duncombe and Yilin Hou, "The Savings Behavior of Special Purpose Governments: A Panel Study of New York School Districts," *Public Budgeting & Finance*, 34(3), 2014.
8. William Duncombe and John Yinger, "Financing Higher Student Performance Standards: The Case of New York State," *Economics of Education Review*, 19(4), 2000; Duncombe and Yinger, "How Much More Does a Disadvantaged Student Cost?" *Economics of Education Review*, 24(5), 2005; Duncombe and Yinger, "Are Education Cost Functions Ready for Prime Time? An Examination of Their Validity and Reliability," *Peabody Journal of Education*, 86(1), 2011.
9. Duncombe and Hou; Arapis et al. (forthcoming).
10. Arapis et al. (forthcoming).

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