



MASBO Statement on School District Fund Balances 2010

There are a number of good reasons for school districts to maintain sufficient reserves: for financial stability, for cash flow, and for maintenance of the district's credit rating. Further, fund balances are frequently derived using local taxes, in whole or in part, and it would be viewed as unfair confiscation for the state to capture those resources. Moreover, allowing school districts to maintain fund balances encourages wiser spending on the part of the districts. Finally, fund balances are in fact required for compliance with state law: state restrictions on the kinds of expenditures that can be made with funds in certain categories stipulate that districts maintain reserve accounts for certain purposes.

Financial Stability

School districts maintain fund balances for **financial stability**, to protect programs that are needed to serve children at times when revenues are uncertain. School districts depend heavily on state aid, and, unfortunately, state aid is sometimes an unstable revenue source. State revenues are highly sensitive to the business cycle, and when the economy is in recession, state aid does not keep up with inflation, and can even be cut. (One can even argue that state aid does not keep up with inflation when the economy is solidly growing.) By maintaining adequate fund balances, school districts are able to use the reserves to maintain educational programs during economic downturns. This is critically important—economic downturns do not reduce the need for education services!

State aid is primarily determined by a school district's enrollment. Enrollment does fluctuate and is not always easy to predict, which further adds to the volatility of state revenues. Enrollment options programs have made it more difficult for school districts to predict enrollment. Family mobility (due to housing and employment changes) also contributes to enrollment fluctuation, and this too can be greater during an economic downturn.

Fund balances also offer financial stability on the expenditure side. Unanticipated expenditure increases do occur, and maintaining an adequate fund balance protects programs when this happens. For example, a spike in natural gas prices, combined with an unusually severe winter, will put many school districts over budget on expenditures for operating buildings.

Most districts engage in multi-year fiscal planning, and fund balances are a critical component of this. Districts often include spending down fund balances as part of a long-range financial plan.

Cash Flow

School districts also need fund balances for **cash flow**, which is a more acute problem during economic downturns. Both expenditures and revenue receipts are not evenly spread throughout the year, so districts often experience cash flow low points over the course of the year. To cover these cash flow low points, districts must maintain fund balances, engage in short-term borrowing, or both.

Cash flow problems have become far more acute for school districts as a result of the state's solutions to its budget problems in 2009. Both the aid payment shift and the property tax recognition shift place

school districts in more difficult positions regarding cash flow; in fact, the amount of state aid payments delayed by these two policy changes exceeds the total of all general fund balances maintained by school districts. Borrowing needs are greater, and yields from investment opportunities are reduced. So far in the 2009-10 school year, at least 128 school districts and 90 charter schools have engaged in borrowing for cash flow purposes. Interest rates for cash flow borrowing have been quite low, due in part to the low rates of return in the economy as a whole, but this is not likely to be true for long. Eventually interest rates will return to “normal” levels and borrowing costs for districts will increase further.

Bond Ratings

Fund balances clearly have an effect on school districts’ **bond ratings**. The Minnesota state credit enhancement program provides a state guarantee of payment of debt obligations by school districts, and school districts receive a higher rating on their bonds as a result. However, many investors are still interested in the “underlying” rating of the school district issuing debt, which is the rating of the district had the state credit enhancement program not been in place. An “Aa” underlying rating versus an “A” underlying rating in today’s market translates into perhaps 20 basis points (0.20%) in interest rates on a long-term issue, or approximately \$250,000 more in interest on a \$10,000,000 bond issue for 20 years.

Rating agencies pay close attention to fund balances in determining underlying ratings. They look at a number of other factors as well, and they will not specify a percentage of fund balance that they regard as optimum, but ratings analysts like to see fund balances in the neighborhood of 10% or more of a year’s expenditures. We also know that school districts that fall into statutory operating debt suffer a long-term penalty in terms of bond ratings. It takes a long time to recover from such a circumstance, in the eyes of the rating agencies.

Bond ratings are not used solely as an indicator of the quality of a school district’s debt. They also are regarded by taxpayers and other stakeholders as a measure of how well their school district is managed. Bond ratings also are used by other vendors, such as property/casualty insurers, as a measure of stability and credit quality.

Fund Balances Built with Local Money

Fund balances are widely regarded as having been **established with local tax levies**. Many districts have passed operating referendum levies to enhance or maintain the quality of educational programs. Often referendum campaigns specifically mention the need to maintain adequate fund balances. If the state were to somehow capture school district fund balances, or reduce state aid for districts with fund balances above a certain level, this would be widely regarded as an unfair confiscation of money contributed by local taxpayers.

Encourage Wiser Use of Money

Allowing school districts to maintain fund balances is **sound policy** and encourages wiser expenditures. Government entities that are required to spend budget resources by a certain date—“use it or lose it”—often make expenditures that, if not wasteful, are at least less than optimum, in order to preserve a budget baseline. Wiser expenditures may occur in the next fiscal year or the next after that, and should be permitted and encouraged by state policy.

Compliance with State Law

Fund balances are needed also to **comply with state law**. State law requires districts to maintain reserve accounts for a variety of revenue sources and programs: operating capital expenditures, staff development, compensatory revenue, area learning centers, health and safety, and many more. These balances are not available for spending for purposes other than those authorized in statute. Reserved fund balance accounts even exist in districts with negative net fund balances. Over 25% of school districts reserves at Fiscal Year 2008 year end consisted of reserved fund balances in compliance with state law.

Optimum Fund Balance

What, exactly, is the optimum fund balance for a school district? There is no simple answer to this; local characteristics must determine that. Things to consider are:

- Enrollment trends; is the district's enrollment falling, stable, or increasing?
- Local economy: strength and diversity of employment base
- Operating levy resources, and future plans
- Bond rating, and plans for debt issuance
- Cash flow needs and characteristics
- Need for reserves to cover commitments, e.g. lease purchase agreements

At the end of Fiscal Year 2008, Minnesota school districts held a total of \$874.5 million of general fund unreserved fund balances, which is equal to \$1,082 per ADM served. This is 11% of the year's expenditures—not an excess amount. In addition, some of these reserves are “designated” for certain purposes, such as an appropriation for lease payments. This is not an excess amount—it is about equal to one month's expenditures during the course of the school year. Many business leaders express surprise at the minimal amount of school district fund balances.

The Government Finance Officers Association has a “Best Practice” Statement regarding the appropriate level of unrestricted fund balance for governmental units. Their recommendation is that, in general, political subdivisions maintain an unrestricted fund balance in the general fund of **no less than two months** of regular general fund revenues or expenditures. Two months, or one-sixth of a year, would be a fund balance of 16.67%. The GFOA recommendation allows for even higher balances if local circumstances warrant this.

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