Report to the Joint Legislative Education Oversight Committee of the North Carolina General Assembly

Submitted by the H1031 Working Group

April 19, 2019

INTRODUCTION

In Section 3 of Session Law 2018-83, "Local Ed. Funding Dispute Process" (originally House Bill 1031), the General Assembly directed the Local Government Commission and the School of Government at the University of North Carolina at Chapel Hill (School of Government) to convene a working group to develop and recommend statutory parameters for fund balances maintained by local boards of education and for disputes related to the capital outlay fund.[1] The General Assembly required that the working group include at least one representative from each of the following groups: the North Carolina Association of County Commissioners, the North Carolina School Boards Association, and the North Carolina Association of School Business Officers. The working group was asked to produce findings and recommendations on the following issues:

(1) Relating to fund balances maintained by local boards of education the following:
- a. Minimum and maximum fund balances, with a focus on unencumbered funds.
- b. Appropriate uses of fund balances.
- c. Annual reporting requirements for fund balances.
- d. A process for factoring fund balances into annual local education budgets.
- e. The role of boards of county commissioners, if any, in determining the use of fund balances.

(2) Relating to capital outlay funds, a mechanism for calculation by formula or other means to resolve disputes related to capital outlay as alternatives to litigation.

The General Assembly directed the working group to provide its findings and recommendations to the Joint Legislative Education Oversight Committee. This report is respectfully submitted to fulfill that requirement.

[1] See https://www.ncleg.gov/Sessions/2017/Bills/House/PDF/H1031v5.pdf.

TASK FORCE FORMATION and MEETINGS

After House Bill 1031 became law, a faculty representative from the School of Government contacted the county and school associations identified in the legislation to solicit appointments for their representatives in a working group. As a result of this outreach and the resulting recommendations, 10 appointed representatives formed the H1031 Working Group in October 2018 and selected their co-chairs. Following the first meeting, one Working Group member withdrew due to an upcoming military deployment and an additional four members were appointed, bringing the total number of county and school representatives to 13.

The Working Group members serve in various roles in county government and school system administration, many with decades of experience and all with technical expertise. In addition to the members, representatives of the Local Government Commission and the School of Government staffed the group as advisors, with the School of Government also providing meeting space and administrative support. A list of Working Group members, staff, and their affiliations appears on the last page of this report.

To meet its charge, the Working Group met in person eight times from October 2018 through April 2019:

- October 10, 2018
- November 16, 2018
- December 12, 2018
- January 10, 2019
- February 1, 2019
- February 25, 2019
- March 25, 2019
- April 15, 2019

At these public meetings, the Working Group reviewed documents, heard presentations, and described conditions in their home counties and school systems; discussed current school funding policies, procedures, laws, and regulations; and debated possible policy and statutory improvements. All meeting agendas, related materials, and recaps are available on the group's website hosted by the School of Government.[2]

[2] See https://www.sog.unc.edu/resources/microsites/h1031-working-group/.

FINDINGS

The Working Group endorses the following findings, which arose from their discussions, deliberations, and review of technical information over the course of eight meetings and related communications.

Relating to Fund Balances

School system fund balances arise from the interaction of federal, state, and local budget processes.

- Typically, a school system attempts to spend its state funds by the end of the state fiscal year (June 30), as appropriate. However, it is not unusual for a system to still be receiving adjustments to its state funding in the last week of June. It is also possible for other sources of funding (federal, local) to carry over as a positive fund balance in the next fiscal year. A school system's relative reliance on federal funds will affect the size of its fund balance.
- Some aspects of school system budgets are front-loaded. Further, state law requires that proposed school budgets be submitted to county commissioners before all sources and amounts of federal, state, and local funding are known. School administrators do not have a complete picture of their funding until the new state fiscal year begins (July 1 or later), but school administrators are typically making important decisions such as hiring by mid-May. Hence, a positive fund balance allows the system to make up for any funding gap. It can also allow for the retention of personnel – for example, teaching assistants – for an indefinite time if the state reduces funding for their positions.
- In some ways, a school system's budgeting context is similar to a county's, in that counties may need to maintain fund balances because the majority of property tax funds are received almost six months after the beginning of each fiscal year. In addition, federal reimbursements for human services and other funded programs are not received until several months after services are delivered. The Local Government Commission recommends that counties and municipalities maintain a fund balance available sufficient to meet their needs; at no time should fund balance fall below 8% of a unit's general fund expenditures. The LGC annually publishes a memorandum with more detailed information on the amount of fund balance a unit should maintain.
- Because school system fund balances are largely from local county dollars, counties become concerned about significant underspending resulting in increases to school fund balances, while school systems may continue to seek additional funding from counties. This is highlighted further in school systems with decreasing ADM. County officials find it difficult to justify appropriating additional tax dollars to school systems where the ADM is decreasing in addition to the significant underspending of county dollars.

- Fund balances allow school systems to smooth out peaks and valleys in revenues and expenditures and reduce the impact of timing issues which are beyond school systems' control.

There is a need for flexibility, as one size does not fit all (or even most).

- Arguably, there has never been a time when there has been so much demographic, geographic, and economic disparity among North Carolina's counties and school systems. This disparity complicates any attempt to set statewide guidelines for minimum and maximum fund balances.
- Fund balances provide school systems with needed flexibility for unforeseen expenses that arise during a fiscal year – for example, emergency repairs due to hurricane and flood damage, which affected eastern North Carolina school systems in the fall of 2018. Similarly, snowstorms in the western part of the state can have a significant financial impact on the schools in that region. School systems have no independent authority to borrow money or levy taxes in such cases.
- It is important to consider local experience. For example, Guilford County Schools began maintaining a significantly greater fund balance after experiencing costs associated with a fire that destroyed one of its high schools in 2006.
- An alternative to maintaining a substantial fund balance is for school superintendents to submit emergency requests to county commissioners when faced with shortfalls, whatever the cause.

More communication and transparency is needed between school systems and their home counties with respect to fund balances.

- Communication and transparency is more likely to limit disputes than setting specific numerical targets for fund balances.
- If unexplained, fund balances that continue to grow attract attention and become the target of legitimate questions from county officials, as do continued underspending of county dollars appropriated to school systems.
- County officials generally oppose a school system funding recurring expenditures out of their fund balance. Recurring expenditures should be funded through a recurring, sustainable revenue source. Fund balance is considered one-time funding. Further, school systems with a decreasing enrollment and an increasing fund balance would likely be subject to scrutiny (especially if the system requests a funding increase). There may be valid reasons for either scenario, but the school system would need to share them with the county.
- There is a need for regular meetings where representatives of county and school system administration are required to share financial trends, goals, and plans for fund balances.

Relating to Capital Outlay Funds

Capital outlay disputes rarely end up in court, in part because both bench and jury trials contain risks for prospective litigants, which incentivizes settlements prior to litigation.

- Joint capital planning between counties and school systems is typically more straightforward than joint operations planning because the former does not depend as much on other funding sources – capital funds come largely from local sources, and state funding for capital has been both nominal and infrequent.
- While the threat of litigation can affect decision-making, capital disputes rarely end up in court, as litigation does not tend to produce outcomes that systematically favor either counties or school systems.
- Bench trials may be fairly accelerated if the presiding judge knows the issues well. Juries, who are less likely to have specific subject matter expertise, are hard to predict and may render unexpected verdicts. In both types of trials, the outcome of litigation is uncertain to prospective litigants.
- Still, under the current structure, one possible approach to a capital dispute could be to proceed through the formal mediation phase without engaging in good faith, in order to begin litigation as quickly as possible.

Any alternative to litigation would need to recognize differences between counties, respect counties' discretion to set prudent tax rates and fiscal policies, and preserve school systems' ability to dispute egregious instances of insufficient funding.

- As with fund balances, a numerical formula is unlikely to adequately determine resources for capital outlay across North Carolina's diverse counties and school systems. Some school systems are growing rapidly and need new facilities in the short term, with more to come in the foreseeable future. Other systems are shrinking and must use their limited resources to maintain the facilities they have, or to consolidate multiple aging, inefficient schools with declining enrollments into a single new facility.
- Commissioners must balance a school system's capital needs with all other mandated responsibilities and county funding requirements. In addition, Commissioners must assess the county's ability to pay, increasing taxpayer burden~~,~~ as well as debt capacity and impact on the county's bond rating. Capital funding initiatives should be consistent with the county's established debt and fiscal policies to prevent impairment of the bond rating.
- School systems depend upon the "backstop of last resort" that litigation provides if counties provide demonstrably insufficient funds for facility improvements and new construction. While such instances are outliers, school systems have used litigation as a recourse to resolve them on rare occasions.

Regular communication and joint planning are likely to make disputes over capital funding less frequent and entrenched.

- As with fund balances, regular communication between counties and school systems tends to reduce the frequency and severity of capital funding disputes.
- School system administrators should encourage county commissioners to tour the facilities in their systems. This has proven to be a valuable practice in some counties that has led to better working relationships and greater understanding of school capital needs between boards of education and boards of county commissioners.

RECOMMENDED STATUTORY CHANGES

Given the findings presented in the previous section, the Working Group members recommend the following statutory changes.[3]

Relating to Fund Balances

Section 1. 115C-426.2 is rewritten to read:

Joint planning.

In order to promote greater mutual understanding of immediate and long-term budgetary issues and constraints affecting public schools and county governments,

(a) local boards of education and boards of county commissioners are strongly encouraged to conduct periodic joint meetings during each fiscal year. In particular, the boards are encouraged to assess the school capital outlay needs, to develop and update a joint five-year plan for meeting those needs, and to consider this plan in the preparation and approval of each year's budget under this Article. <u>The local board of education shall invite the county commissioners annually to tour all or a portion of the school buildings to assess the capital needs over the next five years.</u>

<u>(b) the superintendent and finance officer or other person or persons responsible for budget development for each board of education to whom the county provides funding and the county manager and finance officer or other person or persons responsible for budget development for the county shall meet at least quarterly to discuss funding needs to the school systems and the funding capacity of the county, any known federal or state mandates or other factors that would affect funding capacity of the county or funding needs for the schools, the level and use of fund balances of the county and the school systems, fund balance policies if applicable, capital needs over the next five years, and any other issue deemed pertinent to the school system budget. The superintendent shall organize the meetings in the even numbered calendar years and the county manager shall organize the meetings in the odd numbered calendar years. In a county with multiple local education agencies, the county manager shall determine whether the meetings will be held separately or jointly.</u>

Section 2. 115C-427 is amended to read:

Preparation and submission of budget and budget message.

(a) Before the close of each fiscal year, the superintendent shall prepare a budget for the ensuing year for consideration by the board of education. The budget shall comply in all respects with the limitations imposed by G.S. 115C-432.

[3] While Local Government Commission and School of Government staff advised on technical aspects of proposed policy changes, they did not participate in the drafting of statutory changes and do not take a position on them.

(b) The budget, together with a budget message, shall be submitted to the board of education not later than May 1. The budget and budget message should, but need not, be submitted at a formal meeting of the board. The budget message should contain a concise explanation of the educational goals fixed by the budget for the budget year, should set forth the reasons for stated changes from the previous year in program goals, programs, and appropriation levels, <u>the current year's unassigned fund balance and the amount of assigned fund balance designated for subsequent year's budget appropriation included in the upcoming year's budget,</u> and should explain any major changes in educational or fiscal policy. <u>The budget message shall be transmitted to the board of county commissioners in its entirety when the board of education submits its budget request, pursuant to G.S. 115C-429(a).</u>

Relating to Capital Outlay

Although the working group engaged in substantial discussions over the course of several meetings related to capital outlay and the dispute resolution process, the group was unable to come to a consensus on additional proposed legislative changes beyond those identified in the preceding section on joint planning. This is largely due to the fact that our 100 counties and 115 school districts have vastly different demographics, economic situations, and community demands. Even if a "one-size fits all" solution could be determined, it may create unintended consequences for stakeholders. Several of the working group members are working with the School of Government and the Local Government Commission to create joint county and school system professional development activities. The proposed legislation requiring quarterly meetings and the professional development activities should result in better communication and transparency, and thereby reduce the need for litigation.

WORKING GROUP MEMBERS, STAFF, and AFFILIATION

Members

Stephen Britt*	Chief Finance Officer, Sampson County Schools
Amy Cannon**	Cumberland County Manager
Pam Dubois	Senior Deputy Cabarrus County Manager
Susan Holder	Assistant Sampson County Manager
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Jennifer Mace	Catawba County Budget and Management Director
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Staff

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* Mr. Britt had to withdraw from the group after its first meeting due to an upcoming military deployment.
** Indicates a Working Group Co-Chair.