

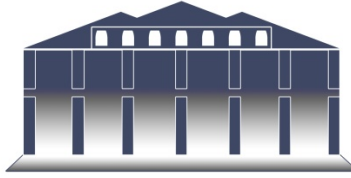
**Local Education Funding Dispute Resolution
Process Is Effective and Economical, but Litigation
Could Be Eliminated**



**Final Report to the Joint Legislative
Program Evaluation Oversight Committee**

Report Number 2017-05

May 1, 2017



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John W. Turcotte
Director

May 1, 2017

Members of the Joint Legislative Program Evaluation Oversight Committee

North Carolina General Assembly
Legislative Building
16 West Jones Street
Raleigh, NC 27601

Honorable Members:

Session Law 2016-116 directed the Program Evaluation Division to evaluate the process for resolving education funding disputes between local boards of education and boards of county commissioners.

I am pleased to report that local boards of education and boards of county commissioners cooperated with us fully and were at all times courteous to our evaluators during the evaluation.

Sincerely,

A handwritten signature in black ink, appearing to read "J. W. Turcotte".

John W. Turcotte
Director



PROGRAM EVALUATION DIVISION

NORTH CAROLINA GENERAL ASSEMBLY

May 2017

Report No. 2017-05

Local Education Funding Dispute Resolution Process Is Effective and Economical, but Litigation Could Be Eliminated

Summary

In North Carolina, local education agencies and local boards of education are fiscally dependent on county commissioners for local appropriations to support capital and operations for public K-12 education. This fiscal dependence plays out each year through a budgeting process wherein local education budgets are presented to county commissioners for appropriations determinations. If in any given year local boards of education and boards of county commissioners cannot reach a budget resolution, state law sets out a procedure for resolving local education funding disputes that is structured into two phases: pre-litigation and litigation.

Concerns have been raised regarding the use and cost of the dispute resolution process. Session Law 2016-116 directed the Program Evaluation Division to evaluate the process for resolving education funding disputes between local boards of education and boards of county commissioners.

North Carolina's dispute resolution process is effective and economical, but the litigation phase could be eliminated. The dispute resolution process is used infrequently and seldom reaches the litigation phase; when the process has been used the outcomes have not historically favored either party and may serve to improve future budgeting efforts. The cost of the process represents a fraction of total county funding for local boards of education, but litigation is costly and time-consuming. North Carolina and Tennessee are the only states with elected school boards that are fiscally dependent on county commissioners; whereas North Carolina has a dispute resolution process that can involve litigation, Tennessee uses a default funding mechanism to avoid litigation.

In addition, local boards of education maintain unencumbered fund balances that are relatively large and unnecessary because their operational needs are different from county government and because the majority of their operational funding comes from state appropriations.

As a result, the General Assembly should consider:

- If it wants to eliminate litigation from the local education funding dispute process, the General Assembly should revise state law for settling local education funding disputes to preserve the benefits of the pre-litigation phase while replacing the litigation process with a default funding mechanism.
- The General Assembly should direct the Local Government Commission and School of Government at the University of North Carolina at Chapel Hill to convene a working group to develop and recommend statutory parameters for fund balances maintained by local boards of education.

Purpose and Scope

Session Law 2016-116 directed the Program Evaluation Division to evaluate the process for resolving education funding disputes between local boards of education and boards of county commissioners. This evaluation addressed three research questions:

1. Is the current dispute resolution process efficient and effective?
2. How do finance practices affect local education funding disputes?
3. What alternatives exist to improve the dispute resolution process?

The Program Evaluation Division collected and analyzed data from several sources, including

- costs, duration, and outcomes for instances in which the dispute resolution process was used between 1997 and 2015;
- survey data from members of local boards of education, boards of county commissioners, and other local staff that have participated in the dispute resolution process;
- historic budget and appropriation data for counties and local boards of education;
- audited fund balance data for counties and local boards of education;
- interviews and queries with key stakeholders; and
- data from other states on their local education funding processes to identify alternatives to North Carolina's current dispute resolution process.

Background

Various laws and judicial opinions provide a framework for North Carolina's system of public education. The State Constitution establishes the requirement that the State provide free public education.¹ Statute specifies the State must provide a general and uniform system of free public schools, wherein equal opportunities are provided for all students.² In 1997 in the *Leandro v. State* case, the North Carolina Supreme Court held that every person of the State less than 21 years old who has not completed a standard high school course of study must be provided an opportunity for a sound and basic education, which the court defined (see the Appendix for more detail on the Leandro case).

Most states use a Basic Education Program (BEP) to establish the standards for a basic education, determine the amount of resources required to fund it, and specify the corresponding sources of those funds. Thus, the BEP drives education funding in those states. North Carolina has a BEP, but the State uses a series of allotments to distribute state and federal funds to local school administrative units, which are commonly and hereafter in this report referred to as local education agencies (LEAs).³ The Department of Public Instruction is responsible for distributing these funds. A previous

¹ Article IX of the Constitution of North Carolina.

² N.C. Gen. Stat. § 115C-1.

³ North Carolina's BEP has not been updated since 1994.

Program Evaluation Division report provides an in-depth examination of K-12 funding allotments.⁴

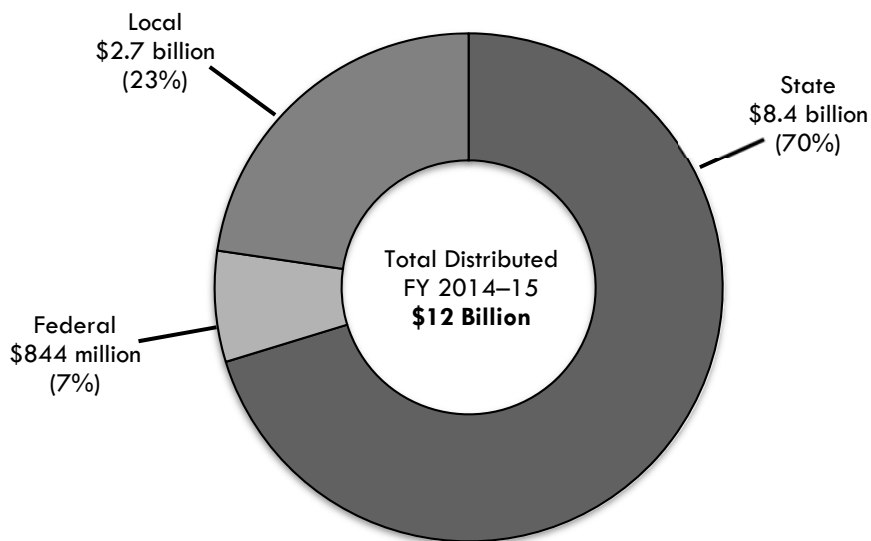
State law assigns specific responsibilities for K-12 funding to different levels of government, but in practice, funding responsibility is shared.

N.C. Gen. Stat. § 115C-408 states it is “the policy of the State of North Carolina to provide from State revenue sources the instructional expenses for current operations of the public school system as defined in the standard course of study. It is the policy of the State that the facilities requirements for a public education system will be met by county governments.” Although statute appears to delineate operational funding as a responsibility of the State and capital funding as a responsibility of county governments, in reality, funding for operations and capital is shared between the State and local governments.

The majority of operational funding for North Carolina’s K-12 public education system comes from the State, but local governments provide a portion of operational funding. Operational expenses include salaries and benefits for school system staff such as teachers, principals, counselors, and central office employees. Exhibit 1 shows the distribution of funding for school operations from state, local, and federal sources in Fiscal Year 2014–15. The majority (70%) of operational funding for public education comes from state appropriations. Local governments account for the second largest source (23%) of funding for operations.

Exhibit 1

Fiscal Year 2014–15
Sources of Public
Education Funding for
Operations



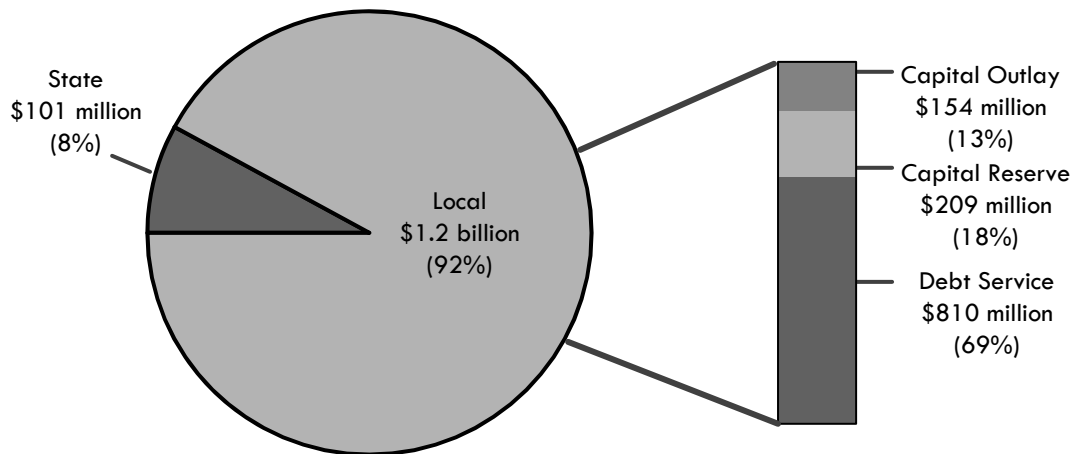
Note: The exhibit does not include resources for child nutrition or other federal funds passed directly to LEAs.

Source: Program Evaluation Division based on data provided by the Department of Public Instruction.

⁴ Program Evaluation Division. (2016, November). Allotment-Specific and System-Level Issues Adversely Affect North Carolina’s Distribution of K-12 Resources. Report to the Joint Legislative Program Evaluation Oversight Committee. Raleigh, NC: General Assembly.

The majority of capital funding comes from local governments, but the State provides a portion of capital funding. Capital expenses include new school construction, renovation, maintenance, and repairs. Exhibit 2 shows the distribution of funding for school capital from state and local sources. Local appropriations for capital in Fiscal Year 2014–15 amounted to \$1.2 billion, or 92% of total funding for capital. Local appropriations are made up of appropriations for debt service, capital reserves, and capital outlay. State appropriations for capital in Fiscal Year 2014–15 amounted to \$101 million, or 8% of total funding for capital.

Exhibit 2: Fiscal Year 2014–15 Sources of Public Education Funding for Capital



Source: Program Evaluation Division based on data provided by the Local Government Commission and North Carolina Association of County Commissioners.

County commissioners are responsible for determining the amount of capital funding and any additional local operating funds to be allocated to local boards of education. Ideally, boards of county commissioners and local boards of education work together to determine local education funding, but actual appropriations are made at the discretion of county commissioners. State law requires that local boards of education maintain funds in a standardized budget format that includes three funds: a Public School Fund, a local current expense fund (for operating expenses), and a capital outlay fund. When appropriating funds to local boards of education, state law requires boards of county commissioners to make appropriations for operations that, when combined with appropriations from the State, are sufficient to allow schools to meet the mandate to provide a sound and basic education. Appropriations for capital are intended to cover the cost of

- acquiring real property for school sites, playgrounds, athletic fields, administrative headquarters, and garages;
- acquiring, constructing, reconstructing, enlarging, renovating, or replacing buildings and other structures, including buildings for classrooms, laboratories, physical and vocational educational purposes, libraries, auditoriums, gymnasiums, administrative offices, storage, and vehicle maintenance;
- acquiring or replacing furniture, instructional apparatus, data-processing equipment, business machines, and similar items of furnishings and equipment; and

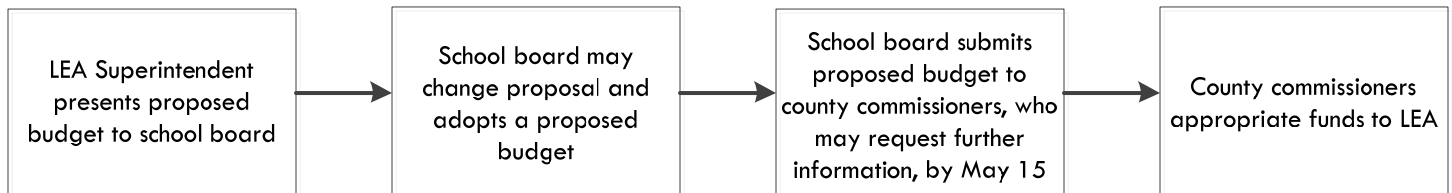
- acquiring school buses, activity buses, and other motor vehicles.

Because boards of county commissioners determine the amount of local revenue to appropriate to local boards of education, county commissioners must engage each year in a detailed budgeting process to estimate revenues and identify funding requirements for the forthcoming year. State law specifies the process that local boards of education and boards of county commissioners must follow to develop a budget for schools within a county. Exhibit 3 shows the general budgeting and local funding process conducted between boards of county commissioners and local boards of education. By May 1 of each year, an LEA's public school superintendent must submit a budget to his or her respective local board of education. Although not required, local boards of education may hold a public hearing on the budget, and they are free to make adjustments to the superintendent's budget. The county's budget officer then presents the local board of education's proposed budget to the board of county commissioners.

The board of county commissioners then determines how much to appropriate to its respective LEA's local current expense fund (for operating expenses) and capital outlay fund. In making these determinations, the board of county commissioners must consider a variety of factors, including but not limited to

- the needs of other county departments such as public health, social services, law enforcement, and elections;
- revenue from other sources;
- local school fund balances; and
- the need for an interim budget.

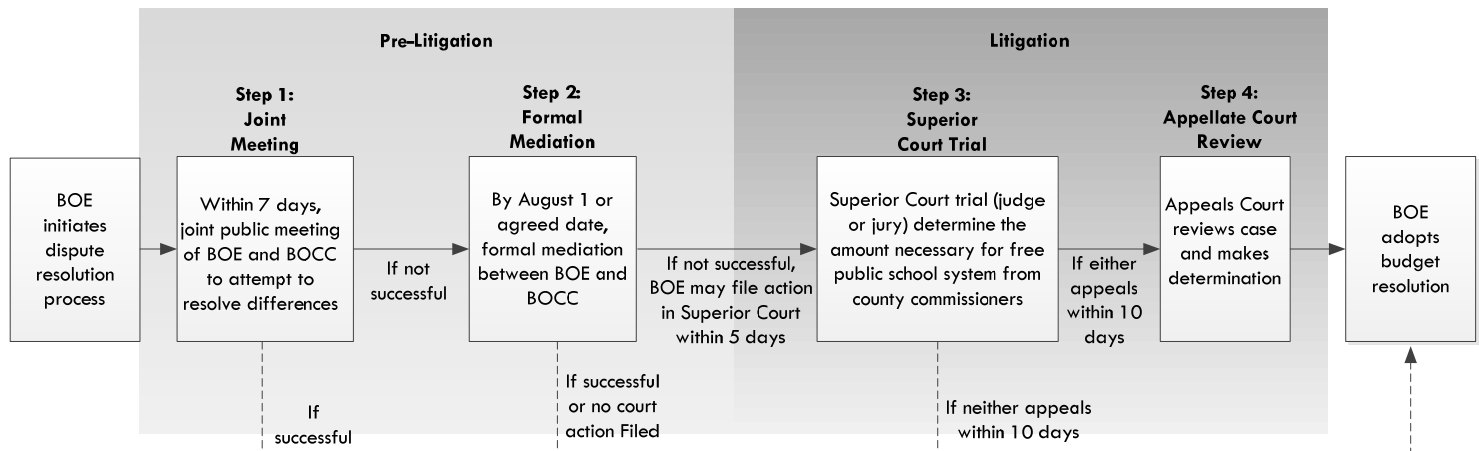
Exhibit 3: General Process of Local Education Budgeting



Source: Program Evaluation Division based on review of state law.

If, after appropriations have been made through the county commissioners' adopted budget ordinance, the local board of education determines the amount of money appropriated is insufficient to support a system of free public schools, the local board of education may initiate a formal education funding dispute. N.C. Gen. Stat. § 115C-431 specifies the four stages of the dispute resolution process. As Exhibit 4 shows, the first two stages make up a pre-litigation phase, whereas the latter two stages involve the State's judicial system and constitute the litigation phase.

Exhibit 4: North Carolina's Local Education Funding Dispute Resolution Process Consists of Pre-Litigation and Litigation Phases



Notes: BOCC stands for local boards of county commissioners, and BOE stands for local boards of education.

Source: Program Evaluation Division based on N.C. Gen. Stat. § 115C-431.

To formally initiate the dispute resolution process in North Carolina, a local board of education must notify the board of county commissioners of this intention within seven days of adoption of the county budget ordinance. State law specifies that the dispute resolution process consists of four stages.

- Stage 1 (Joint Meeting).** During this stage, the two boards participate in a joint public meeting with a mediator in an attempt to resolve funding differences within seven days of the initiation of the process. If this meeting is successful, the local board of education will adopt a budget resolution based on the county commissioners' revised budget ordinance if it has been revised.
- Stage 2 (Formal Mediation).** If the joint meeting in Stage 1 is not successful, the boards must enter into formal private mediation, which must conclude by August 1 of that year or at a mutually agreed upon date. During this stage, the boards select a mediator to preside over formal mediation between them, and each board shares equally in the costs that mediation incurs. If mediation is successful, the local board of education will adopt a budget resolution based on the county commissioners' revised budget ordinance if it has been revised.
- Stage 3 (Superior Court Trial).** If mediation is not successful, the local board of education may file action in Superior Court and enter the litigation phase of the process. State law specifies that the court is to take the matter up as soon as possible, though it does not set a deadline for completing this stage. The judge or jury must consider the facts of the case in the following order: the amount legally necessary from all sources and then the amount legally necessary from the board of county commissioners in order to

maintain a system of free public schools. In making this determination, the judge or jury must consider the budgetary request, educational goals and policies of the State and local board of education, and financial resources and fiscal policies of both local boards. If the judge or jury determines additional funds are needed to maintain a free public school system and the local government does not have the current capacity to meet those needs, the judge or jury can specify where additional funding should come from, such as a tax increase on local property.

- **Stage 4 (Appellate Court Review).** Either the board of county commissioners or the local board of education has the opportunity to appeal the Superior Court's ruling within 10 days of a decision. Unlike the requirement in Stage 3 for Superior Court to take up the action as soon as possible, state law does not establish a similar requirement for the timing of an appellate review in Stage 4. It is not uncommon for the appellate review process to take more than a year to complete.

The local education funding dispute resolution process has received attention in recent years. Exhibit 5 shows a summary of significant legislative and judicial actions relating to the dispute resolution process since 1975. In 2009 in *Beaufort County Board of Education v. Beaufort County Board of Commissioners*, the North Carolina Supreme Court held local governments are not only responsible for capital expenditures as specified in statute but are also required to provide operating funds to local boards of education in order to fulfil its obligation to provide equal opportunity for a sound and basic education for students (see the Appendix for more detail on the Beaufort case). In 2015 in *Union County Board of Education v. Union County Board of Commissioners*, the North Carolina Court of Appeals held that a judge or jury cannot consider cumulative funding deficiencies but only the request and appropriation in the year of the dispute (see the Appendix for more detail on the Union case).

Session Law 2016-116 directed the Program Evaluation Division to examine the use and cost of the process to resolve local education funding disputes between boards of county commissioners and local boards of education. Although state law specifies the process the two boards must follow, it does not assign any entity responsibility to maintain data on the procedure. As a result, the Program Evaluation Division collected and reconciled lists on the use of the process between 1997 and 2015 from various sources.⁵ Data requests to boards of county commissioners and local boards of education were made for each instance in which the process was initiated. These requests sought to determine the stage at which each dispute was resolved, how long the dispute lasted, the cost of settling the dispute, and the outcome of the dispute. Much of the data requested was available and provided; however, gaps in data exist because information was either missing or destroyed when record retention requirements expired. As a result, many of the statistics presented in this report are estimated summaries based on available data.

⁵ The Program Evaluation Division selected 1997 because it was the year that statute changed the dispute resolution process to include mediation.

Exhibit 5: Legislative and Judicial Action Related to Local Education Funding Disputes

	Legislative Action	Judicial Action
1975	S.L. 1975-437, School Budget and Fiscal Control Act, requires boards of county commissioners and local boards of education to meet regarding funding disputes; if no resolution is reached, either board can refer dispute to clerk of superior court for arbitration within three days of joint meeting; either board can appeal clerk's decision to Superior Court within 10 days.	
1981	S.L. 1981-423 recodifies Chapter 115.	
1989	S.L. 1989-493 adds provision stating that if within 10 days of referral the clerk of court determines the dispute cannot be arbitrated, the dispute is then referred to Superior Court.	
1995	S.L. 1995-666 removes clerk of court as arbitrator; directs clerk to request the appointment of a mediator by superior court within 5 days of dispute referral to clerk's office; and changes the time by which either board must file court action following the mediator's recommendation from 10 days to 5 days.	
1997	S.L. 1997-222 stipulates the following: the mediator presides at joint meeting of the boards; the two boards may select the mediator rather than using a court-appointed mediator; the mediator does not make recommendations to the clerk of Superior Court for resolution of the dispute; and the mediation process must be concluded by August 1 unless both parties agree to an extension.	
2007	S.L. 2007-92 enacts a new provision ensuring that any appeal of a funding dispute is not affected if the fiscal or school year in contention ends before the issue is resolved.	
2009		In <i>Beaufort County Board of Education v. Beaufort County Board of Commissioners</i> , the North Carolina Supreme Court issues opinion upholding lower court determination, finding the dispute resolution process does not delegate to the courts the legislature's constitutional duty to provide a general and uniform system of free public schools. The case held a court cannot require a county to fund more than the minimum level of educational funding that is required by state law and a county's funding responsibility for its LEA is not limited to capital outlay.
2013	S.L. 2013-141 clarifies that the issue submitted to the jury must be what amount of money is necessary from all sources to maintain a system of free public schools and what amount of money is needed from the county to make up this total.	
2014	S.L. 2014-8 directs Union County Commissioners to appropriate specific sums, to establish a working group including the Union County Board of Education to determine capital needs, and bans this board of education from engaging in the dispute resolution process until the county's 2016-17 budget is adopted. The session law also bans boards of education in Nash and Gaston counties from engaging in the dispute resolution process.	
2015		In <i>Union County Board of Education v. Union County Board of Commissioners</i> , North Carolina Court of Appeals issues opinion ordering new trial because trial court allowed improper legal standing and ordered the jury to hear inadmissible evidence of the cumulative effective of underfunding on the school district. The case specified the judge or jury must consider only a single year of funding as the basis for the dispute, and evidence of cumulative funding deficiencies is not permissible.
2016	S.L. 2016-116 directs the Program Evaluation Division to study the dispute resolution process. S.L. 2016-14 and S.L. 2016-18 exempt Nash and Union counties from the dispute resolution process.	
2017	H.B. 305/S.B. 531 (School Boards Can't Sue Counties) filed to revise dispute resolution process.	

Source: Program Evaluation Division based on review of session laws, statutes, and judicial opinions.

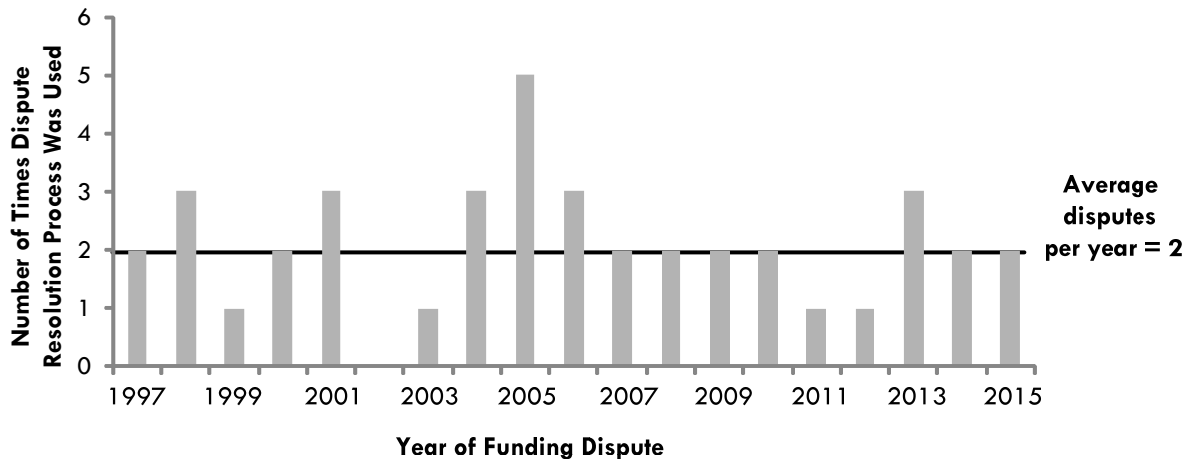
Findings

Finding 1. The dispute resolution process is used infrequently and rarely results in litigation between boards of county commissioners and local boards of education.

N.C. Gen. Stat. § 115C-431 establishes the procedure to resolve local education funding disputes between boards of county commissioners and local boards of education. The statute describes a four-stage process that is separated into two distinct phases: pre-litigation and litigation. The Program Evaluation Division conducted analysis based on the frequency with which the process was used and the phase and stage of dispute resolution.

Between 1997 and 2015, the local education funding dispute resolution process was used 40 times, or in 1.9% of local K-12 education budget resolutions. Between 1997 and 2015, the 115 Local Education Agencies (LEAs) passed a total of 2,070 local budget resolutions. In that timeframe, the local funding dispute resolution process was initiated 40 times, or for 1.9% of budget resolutions. Exhibit 6 shows a count of each instance in which the dispute resolution process was used between 1997 and 2015. The process was mostly used once or twice a year during this period.

Exhibit 6: Procedure to Resolve Local Education Funding Disputes Has Been Used Infrequently



Source: Program Evaluation Division based on data provided by the North Carolina Association of County Commissioners, North Carolina School Board Association, and University of North Carolina School of Government Board Association.

During this span, the process was used by 25 different local boards of education. Because the process is typically viewed as being contentious, most local boards of education have only used it once. However, nine local boards of education have used the process more than once; the Burke, Halifax, Northampton, and Union local boards of education have each used it three or more times.

Of the 40 instances in which the dispute resolution process has been used, resolution was reached prior to litigation in approximately 90% of cases. The pre-litigation phase for handling local education funding disputes serves as a useful step to avoid litigation. Pre-litigation forces both parties to engage in the budgeting process, establishing open dialogue in an environment that promotes transparency. The Program Evaluation Division’s analysis revealed that in approximately 90% of cases

in which the dispute resolution process was used between 1997 and 2015, resolution was reached in either Stage 1 or Stage 2 of the pre-litigation phase. These results suggest that Stages 1 and 2 are successful at helping boards of county commissioners and local boards of education reach budget agreements and avoid litigation.

Of the 40 instances in which the dispute resolution process has been used, litigation has been necessary on only 4 occasions. Exhibit 7 shows the frequency of litigation in the context of all local education budget resolutions passed between 1997 and 2015. Litigation served as the means to reach local education budget resolution only 4 times during this period, which represents 0.19% of the 2,070 total local budgeting ordinances passed between 1997 and 2015. In summary, the dispute resolution process is used infrequently and rarely results in litigation between boards of county commissioners and local boards of education.

Exhibit 7: Between 1997 and 2015, Litigation Was Only Necessary for a Fraction of Local Education Funding Resolutions

Between 1997 and 2015, **2,070 education budget ordinances** were passed between local boards of education and boards of county commissioners.



\$ = **10 annual education budget ordinances** passed by local boards of education and boards of county commissioners



Of the 2,070 education budget ordinances, the funding dispute resolution process was used **40 times, or for 1.9% of the total number of ordinances.**



Of the 2,070 education budget ordinances, litigation was necessary **4 times, or for 0.19% of the total number of ordinances.**

Source: Program Evaluation Division based on data provided by the North Carolina Association of County Commissioners, North Carolina School Board Association, and University of North Carolina School of Government Board Association.

Finding 2. Only 4 of the 40 local education funding disputes proceeded to the litigation phase between 1997 and 2015, but these cases proved disproportionately time-consuming and costly compared to disputes resolved in the pre-litigation phase.

Session Law 2016-116 directed the Program Evaluation Division to estimate the cost of the dispute resolution process. The costs incurred during the process are a function of the time spent by both parties as well as the fees paid for mediation and legal consultation. By law, mediation costs are split between the board of county commissioners and local board of education. Both boards secure legal services as needed to navigate the stages of the dispute resolution process. As a result, the longer the dispute resolution process takes, the greater the cost.

State law regarding the process imposes deadlines that strive to ensure timely resolution, but funding disputes that require litigation are typically resolved long after the year of the dispute. As discussed in the Background, state law specifies a four-stage dispute resolution process that is separated into two phases: pre-litigation and litigation. Boards of county commissioners and local boards of education must complete the two stages of the pre-litigation phase according to statutory deadlines. However, the two stages of the litigation phase have no deadlines. As a result, funding disputes that require litigation take far more time to complete than disputes that are resolved during pre-litigation. Exhibit 8 summarizes the deadlines imposed by statute for each stage and the average number of days needed to reach resolution by phase.

Exhibit 8: Disputes Resolved During Pre-Litigation Take Far Less Time Than Disputes That Reach Litigation

Dispute Resolution Stage	Statutory Deadline	Estimated Days to Resolution
Pre-Litigation		
Joint Meeting	115c-431(a) requires chairs of the board of county commissioners and local board of education to hold a joint meeting within 7 days of the decision of appropriations.	Average = 57 days Maximum = 154 days
Formal Mediation	115c-431(b) states mediation shall end no later than August 1 unless both parties agree otherwise.	
Litigation		
Superior Court Trial	115c-431(c) states that trial must be set for the first succeeding term of the Superior Court, but state law does not set a deadline for completing this stage.	Average = 638 days Maximum = 1,184 days
Appellate Court Review	115c-431(d) states that notice of appeals must be filed within 10 days of judgment, but state law does not set a deadline for completing this stage.	

Source: Program Evaluation Division based on N.C. Gen. Stat. § 115C-431.

On average, funding disputes that end in the pre-litigation phase are resolved within 60 days, with the lengthiest dispute taking 154 days. Such an outlier can occur because the mediation stage provides an opportunity to extend the deadline if both board chairs agree to do so. Nevertheless, given the average length of time it takes to resolve disputes in the pre-litigation phase, it can be inferred that in most cases the process adheres to statutory deadline of August 1. In contrast, when the disputing parties

resort to litigation, on average, funding disputes take 638 days to resolve. In one instance, the process took 1,184 days.

The amount of time it takes to resolve funding disputes when the parties enter into litigation is especially problematic because the additional funds that were the premise of the funding dispute in the first place are not appropriated until after the budgeted year has ended. Consider the 2013 funding dispute between the Union County board of county commissioners and its local board of education. The dispute resolution process was initiated in August 2013. This particular dispute went through the appeal stage before resolution was reached in June 2015—two full school years after the dispute began.

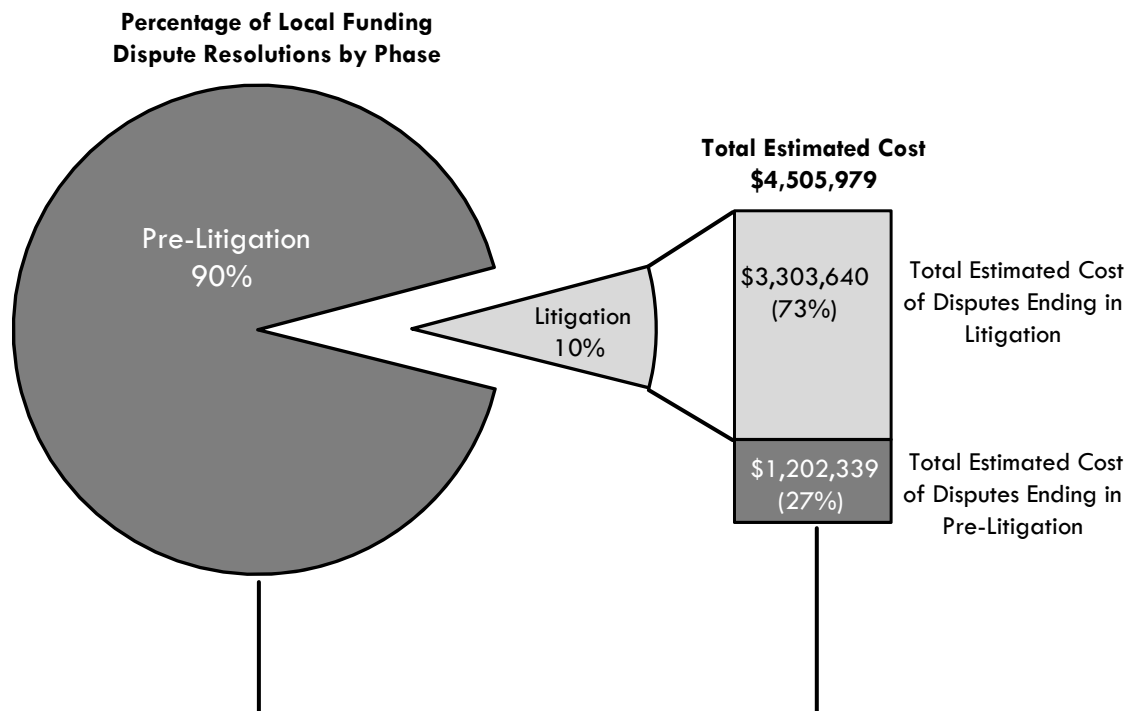
Between 1997 and 2005, the estimated total cost of the dispute resolution process represents a fraction of what was eventually appropriated to local boards of education in the year of dispute.

Concerns have been voiced regarding the cost of settling local education funding disputes. To estimate the cost of funding the process, the Program Evaluation Division collected mediation and legal fee cost data in instances in which the process was used between 1997 and 2015. Analysis of the data show the total estimated cost of the dispute resolution process was \$4.5 million over these 18 years.⁶ These costs were borne entirely by counties. Though this amount is substantial, it represents only 0.5% of the total funds eventually appropriated to local boards of education in the year in which they had a dispute (\$834 million).

The litigation phase incurred a disproportionately high share of the costs of the dispute resolution process as compared to the pre-litigation phase. Exhibit 9 shows that although litigation was necessary in only four funding disputes (10% of cases), their combined costs represent 73% of the estimated total cost of the dispute resolution process for the time period reviewed. In summary, a fraction of local education funding disputes proceed to the litigation phase, but these cases prove disproportionately time-consuming and costly compared to disputes resolved in the pre-litigation phase.

⁶ The estimated cost of the dispute resolution process was calculated based on the average cost to resolve funding disputes at each stage. The cost is a function of the fees paid by boards of county commissioners and local boards of education for mediation and legal representation. The estimate does not include an apportionment of time spent by staff.

Exhibit 9: Only 10% of Funding Disputes Require Litigation, but Litigated Disputes are Responsible for 73% of Estimated Costs



Source: Program Evaluation Division based on data provided by boards of county commissioners and local boards of education that engaged in the dispute resolution process between 1997 and 2015.

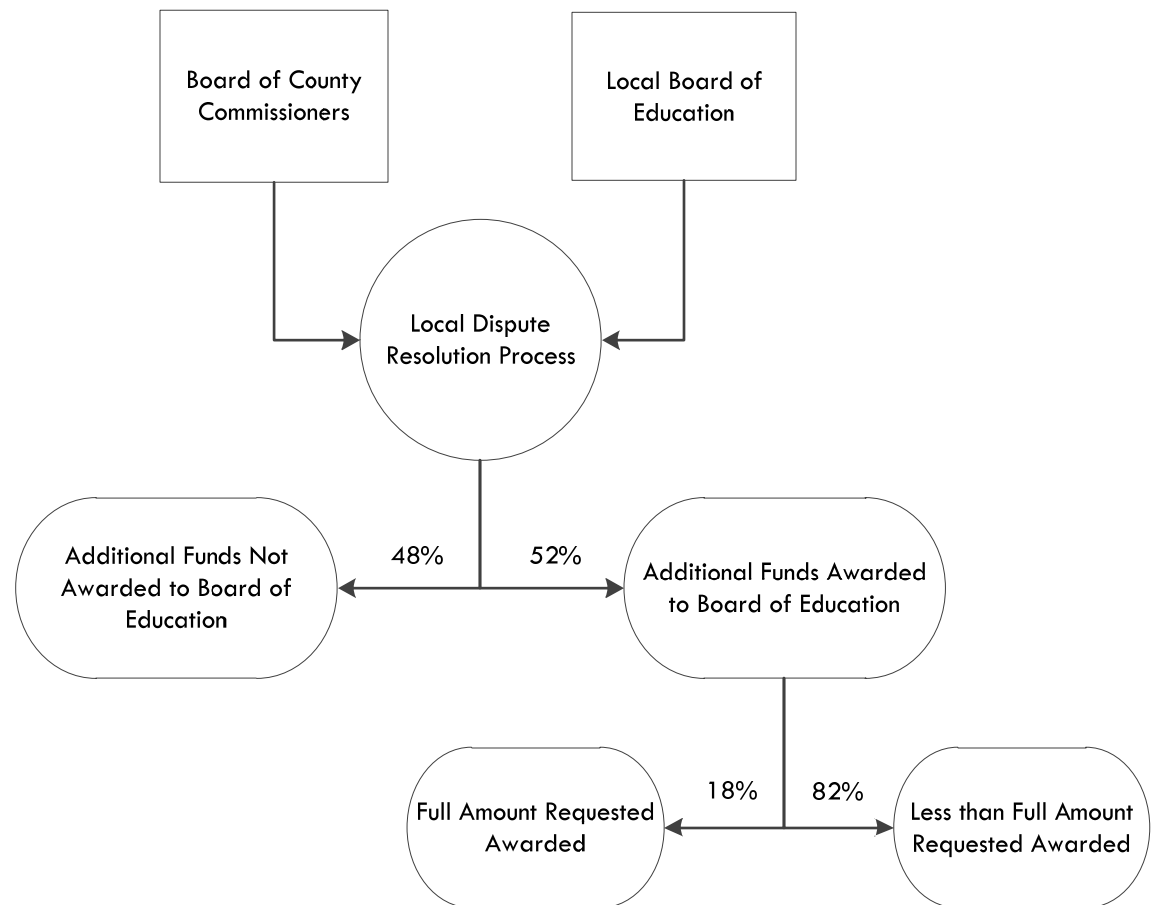
Finding 3. The funding-related outcomes of the dispute resolution process do not favor one party over another, and non-funding-related outcomes of the first two stages may improve future local education budgeting efforts.

Assessing the effectiveness of a formal dispute resolution process between two or more entities requires an examination of the process’s outcomes; this evaluation focused on financial and nonfinancial outcomes.

Overall, financial outcomes of the dispute resolution process have not favored either party involved. The dispute resolution process starts with local boards of education seeking more funding from their boards of county commissioners than was awarded in the initial budget ordinance. Boards of county commissioners then have a second opportunity to examine local board of education requests to determine if they want to award more funding. Whereas local boards of education are seeking an outcome wherein they are awarded additional funds, boards of county commissioners are likely seeking a financial outcome that aligns with their original budget ordinance.

Some stakeholders believe that once a local board of education engages in the dispute resolution process, it will always receive additional funding, but the data do not support this perception. Exhibit 10 maps the procedure’s financial outcomes between 1997 and 2015.

Exhibit 10: Financial Outcomes of Dispute Resolution Process Do Not Consistently Favor Local Boards of Education or Boards of County Commissioners



Source: Program Evaluation Division based on data collected from cases in which the dispute resolution process was used between 1997 and 2015.

As Exhibit 10 shows, the process yielded additional funding in a little more than half of all instances. Both boards of county commissioners and local boards of education experienced near equal funding outcomes; 48% of cases resulted in no additional funding to local boards of education, whereas 52% of cases resulted in additional funding for local boards of education. However, in the 52% of instances in which local boards of education received additional funds, only 18% received the amount requested, whereas the other 82% received less than the amount requested. Engaging in the dispute resolution process does not guarantee that local boards of education will receive additional funds, and even if more funds are awarded, they are likely to be lower than the amount requested.

Regardless of the financial outcome in a given dispute, the dispute resolution process can establish practices or agreements that improve future budgeting interactions between boards of county commissioners and local boards of education. The goal of the dispute resolution process is not only to resolve a particular funding dispute between the board of county commissioners and local board of education but also to positively shape future interactions between the two entities. Whereas the dispute resolution process produces a clear financial outcome (local board of

education receives all, some, or none of the requested amount of funding), non-financial outcomes are less tangible but can have substantial and long-term effects by influencing future budgeting interactions.

In some instances, non-financial outcomes materialize as formal budgeting processes or practices. For example, past dispute resolution processes have resulted in the introduction of bond referendums, implementation of student-based formulas, and approval of multiyear funding agreements. These approaches aid the budgeting process by building in more stability. Ultimately, these approaches may help avoid future conflicts.

Non-financial outcomes of the process that serve to improve future budgeting efforts emerge from the pre-litigation phase. The pre-litigation phase of the dispute resolution process involves structured communications between boards of county commissioners and local boards of education. A mediator serves as a facilitator to begin discussions in Stage 1 of the process and then serves as a formal mediator in Stage 2. These facilitated discussions, along with any additional public and private meetings, help establish lines of communication. Subsequently, transparency is increased, which may help establish understanding and foster trust. As discussed in Finding 1, in 90% of cases in which the dispute resolution process was initiated between 1997 and 2015, the dispute was resolved prior to litigation. These outcomes indicate that many of the non-financial benefits of the process are attributable to the pre-litigation work that is forced upon both parties.

Finding 4. North Carolina and Tennessee are the only states with elected school boards that are fiscally dependent on county commissioners; whereas North Carolina has a dispute resolution process that can involve litigation, Tennessee uses a default funding mechanism to avoid litigation.

North Carolina and Tennessee are the only two states with fiscally dependent and elected school boards. The Program Evaluation Division was directed to examine the dispute resolution processes of other states similar to North Carolina.⁷ In considering which states to compare with North Carolina, the Program Evaluation Division examined two criteria: (1) the fiscal dependency of local school boards on local governments and (2) the method of selecting members of local school boards. Exhibit 11 shows North Carolina and Tennessee are the only two states with fiscally dependent and elected school boards.

States vary in the extent to which their school boards can levy taxes sufficient to fund their educational requirements.

- **States with fiscally independent school boards.** School boards that are fiscally independent have the ability to raise revenue through their taxing authority (such as levying property taxes or sales taxes). Thus, these school boards do not rely on another local government for local education funding. School boards in 40 states have taxing authority and are therefore fiscally independent from other local governments.

⁷ Session Law 2016-116.

- **States with fiscally dependent school boards.** School boards that are fiscally dependent have little or no taxing authority and must instead rely on other local governments (such as boards of county commissioners or city councils) for local funds for education. School boards in nine states, including North Carolina, are fiscally dependent.⁸

Exhibit 11: North Carolina is One of Two States with Elected and Fiscally Dependent School Boards

Method of Selecting Local School Board Members	Number of States with Fiscally Dependent Local School Boards	Number of States with Fiscally Independent Local School Boards	Total
Appointed Boards	1 (ME)	0	1
Elected Boards	2 (NC, TN)	37 (AK, AR, AZ, CA, CO, DE, FL, GA, IA, ID, IL, KS, KY, LA, MI, MN, MO, MT, ND, NE, NH, NM, NV, NY, OH, OK, OR, PA, SC, SD, TX, UT, VT, WA, WI, WV, WY)	39
Hybrid Model	6 (AL, CT, MA, MD, RI, VA)	3 (IN, MS, NJ)	9
Total	9	40	49

Notes: Although most school boards are elected in North Carolina, a small number are appointed school in city LEAs. In Massachusetts, state law provides for elected school boards and local acts of the legislature allow for cities to have appointed school boards. In New York, all but two school boards (New York City and Yonkers) are elected, and all but five school districts (New York City, Yonkers, Buffalo, Rochester, and Syracuse) have taxing authority. In Pennsylvania, only one school board (Philadelphia) is not elected and all other school boards have taxing authority. In South Carolina, 78 of 85 school boards are elected, and 23 school boards have taxing authority. Because Hawaii’s system of public schools is a state-only system with no local school boards and no local funding, it was not included.

Source: Program Evaluation Division based on review of other states and Johnson’s (2009) doctoral dissertation for Virginia Commonwealth University entitled *School Board Taxing Authority in Virginia*.

The Program Evaluation Division also identified states that are similar to North Carolina in terms of how their school board members are selected. Whereas the policy positions of school board members who are elected tend to represent the will of the electorate, the policy positions of school board members who are appointed tend to align with the individual or entity making the appointment. Therefore, it is more likely that elected school boards can maintain independence from other units of government when making education funding decisions.

⁸ States with fiscally dependent school boards, such as North Carolina, may have the option to enact a local supplementary tax to fund education. However, in North Carolina, this tax is collected by the State and remitted to local governments and few local school boards receive revenue from such taxes.

- **States with elected school boards.** Most states (n = 39), including North Carolina, have school board members that are elected by citizens in the district.⁹
- **States with appointed school boards.** Only one state (Maine) has appointed members of local school boards.
- **States with hybrid school boards.** Nine states have a hybrid model of electing and appointing members of local boards of education. In these states, some boards are appointed, some boards are elected, and some boards are determined by other defined arrangements.

North Carolina appears to be the only state with a statutory process for reconciling local education funding disputes. As discussed in the Background, most states have a Basic Education Program (BEP) that establishes the standards for a basic education, determines the amount of resources required to fund it, and specifies the corresponding sources of those funds. Education funding in North Carolina is not driven by a BEP but rather a series of allotments. Without a BEP specifying the costs and funding sources for maintaining a system of basic education, North Carolina's local governments have discretion in fulfilling their role in this system. Boards of county commissioners appropriate local education funds at a level they determine to be adequate, and no minimum amount is required. When a local board of education believes the amount appropriated by its board of county commissioners is not adequate, the local board of education can engage in the dispute resolution process specified in statute. As discussed in the Background, after Stage 2 the dispute resolution process enters a litigation phase.

Unlike North Carolina, Tennessee statute does not provide for a dispute resolution process but instead specifies a default funding mechanism to address any disagreements over local educating funding. Exhibit 12 shows similarities and dissimilarities between North Carolina and Tennessee regarding their local education funding processes. Although Tennessee law does not provide for a formal dispute resolution process, it contains mechanisms that encourage negotiations between local governing boards and school boards and guarantees a certain amount of funding for local school boards.

Exhibit 12

Unlike North Carolina, Tennessee Requires Local Governments to Appropriate Specific Amounts to Local Boards of Education

Aspect of Local Education Funding Processes	North Carolina	Tennessee
Formal dispute resolution process	✓	✗
Statutory timeframe for local education budget development	✓	✓
Required minimum funding amount to local school boards from <i>state</i> through BEP	✗	✓
Required minimum funding amount to local school boards from <i>local governments</i> through BEP	✗	✓

Source: Program Evaluation Division based on review of North Carolina and Tennessee statutes.

⁹ North Carolina has a small number of appointed school boards in city LEAs.

Prior to 2016 in Tennessee, local school boards believing they would receive inadequate funding from local governing boards sought relief through the state's court system. In 2016, the Tennessee General Assembly revised the method by which education funding disputes are handled. Under this new process, if a county legislative body and school board fail to agree upon a budget for the department of education by August 31, the county's education budget defaults to the minimum budget required to comply with the local match and maintenance of effort provisions of Tennessee's BEP.¹⁰ Although this minimum effort is similar to North Carolina's requirement that boards not reaching an agreement by a specified date receive a minimum funding amount, North Carolina's statute only guarantees that a local board of education will receive the same amount as the year prior to the dispute.¹¹

Under Tennessee's new process, if the local governing board and school board do not agree on a budget for three consecutive years, the minimum amount appropriated to the school board increases by 3% of the required funding amount from local sources.¹² As a result, this process penalizes both local governing boards and school boards that refuse to negotiate, but it does not feature a litigation phase. North Carolina statute does not include a mandatory increase for consecutive budget disagreements and instead reverts to an annual process beginning with a formal joint meeting that can end in litigation. The outcomes of Tennessee's statutory modifications are unknown at this time because the changes were put in place in 2016. Tennessee offers a framework for replacing litigation with a default funding mechanism; however, it is yet to be determined how much the threat of litigation serves as incentive to reach a budget resolution. As a result, the consequences of using a similar default funding mechanism approach in North Carolina are unknown.

Like North Carolina, Tennessee provides a specific timeframe for local governments and local school boards to reach budget agreements.

Tennessee law specifies the processes and timeframes local governments and school boards must follow during the budgeting process, which consists of three steps:¹³

- First, if a county commission committee rejects a school board's budget request, the school board is allowed 10 days to revise and resubmit its proposed budget.
- Second, if the school board's budget is rejected by a county commission committee again, the school board again has 10 days to revise and resubmit a budget proposal.

¹⁰ Tenn. Code Ann. § 5-21-111. The local minimum budget required to comply with the BEP is typically the prior year's amount and any additional amount determined by a formula. Local governments not agreeing on a budget resolution must fund their respective school boards at full maintenance of effort and do not have the ability to reduce this amount if needed for circumstances such as reduced revenues.

¹¹ N.C. Gen. Stat. § 115C-431(b).

¹² Tenn. Code Ann. § 5-21-111. The 3% mandatory increase in spending only occurs if school boards submit their budget proposals in accordance with the statutory timeframe and if they received the minimum required funding amount for that fiscal year.

¹³ Tenn. Code Ann. § 5-21-110(e). Pursuant to Tenn. Code Ann. § 5-21-110(f), this timeline and process may be waived or altered if both boards agree to do so.

- Third, if the school board's budget proposal is rejected more than twice by a county commission committee, the third proposed budget of the school board moves directly to the full county commission, after which the school board again has 10 days to revise and resubmit its proposal.

Unlike North Carolina, Tennessee clearly delineates the minimum amounts both the state and local governments must contribute annually to education. Tennessee funds its primary school system through the state's BEP, a weighted formula that specifies the amounts the state and each respective local government must contribute for education.¹⁴ In determining the amount local governments must allocate to school boards, the BEP considers economic differences and the ability of local communities to generate revenue.¹⁵ As such, the BEP attempts to address inadequacies and inequities in Tennessee's school funding by determining the funding level required for each school system to provide a common, basic level of service for all students. However, it is permissible for local governments to contribute more than the minimum amount the BEP requires.

Exhibit 13 shows the four components within Tennessee's BEP that determine the required state and local portions of education funding.¹⁶ Local governments in Tennessee are statutorily responsible for 25% of the costs of classroom components (such as textbooks and supplies), 50% of costs of non-classroom components (such as transportation and capital outlay), 30% of the costs for instructional wages and salaries, and 30% of costs for instructional benefits.¹⁷

¹⁴ Tenn. Code Ann. § 49-3-351. Tennessee funds other initiatives at the local level in addition to the BEP; however, this program accounts for the majority of K-12 education funding in the state.

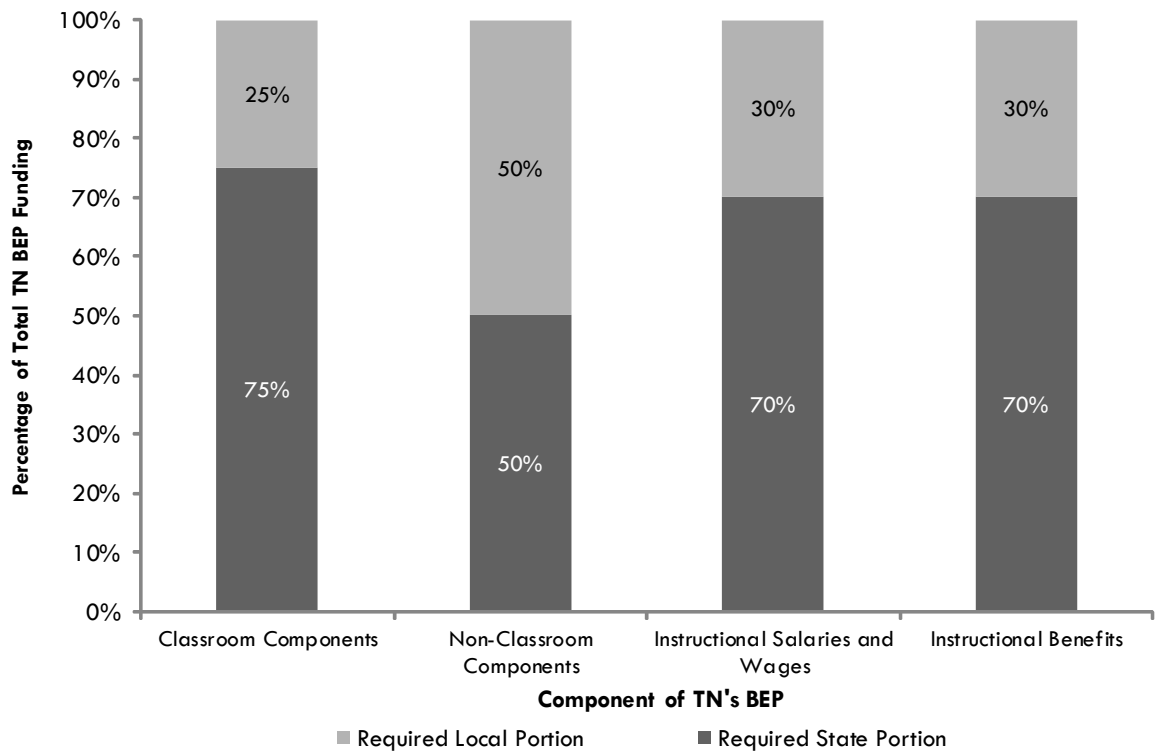
¹⁵ Tenn. Code Ann. § 49-3-307(10)(A) specifies that a local jurisdiction's ability to raise revenue is measured by its ability to generate property tax and local option sales taxes. The calculation is based on applying the statewide average property tax rate for education and the statewide average local option sales tax rate for education to the respective tax bases of each local jurisdiction. Statute specifies that no reduction can be made in any calculation of a local jurisdiction's ability to raise local revenues from property taxes for agreements entered into by the jurisdiction that result in payments rather than taxes being made to the local jurisdiction. Tenn. Code Ann. § 49-3-307(10)(B) weighs these factors through a multiple regression analysis model.

¹⁶ Tenn. Code Ann. § 49-3-307.

¹⁷ Tennessee's BEP further specifies the amounts the state must appropriate for certain populations of students.

Exhibit 13

Tennessee Law Specifies the Amount of Educational Funding Required from the State and Local Governments



Source: Program Evaluation Division based on Tennessee statutes.

In summary, North Carolina and Tennessee are the only states with elected school boards that are fiscally dependent on local governments for local education funding. North Carolina is unique in that it has a statutory process to resolve disputes between local governing boards and school boards, and this process can culminate in litigation. Unlike North Carolina, Tennessee statute also specifies that if local governing boards and school boards fail to reach a budget agreement by August 31 of any year, the local government must fund the school system at a minimum pre-defined level established by the state's BEP. Tennessee law requires local governments to fund the minimum level and an additional 3% if the two boards do not reach a budget agreement for three consecutive years. Tennessee's default funding mechanism prevents litigation from being a part of its dispute resolution process.

Findings 1 through 3 demonstrate the dispute resolution process is used infrequently and seldom results in litigation. When used, the process's design seeks to mitigate the amount of time and resources spent. In the aggregate, the financial outcomes of the process have not favored either party, and the non-financial benefits that typically arise during pre-litigation stages can improve future local education budgeting efforts. On the other hand, the litigation stages are costly and time-consuming, leaving both boards of county commissioners and local boards of education short on needed resources. This Finding discussed an alternative method for settling local education funding disputes based on a Tennessee model that does not include litigation. Based on these findings, it can be concluded that an alternative to the litigation phase of the dispute resolution process can be accomplished that still preserves many of the benefits of the pre-litigation phase of the current process.

The next finding addresses a specific study provision that directed the Program Evaluation Division to examine fund balances, an important local education budgeting factor that can lead to local education funding disagreements.

Finding 5. Local boards of education maintain relatively large unencumbered fund balances, which can contribute to funding disagreements and result in local resources being withheld from K-12 public schools.

A common accounting practice when reporting on government operations and finances is to provide information regarding a government entity's fund balance. A fund balance is the difference between the assets and liabilities in a government fund and generally represents a reserve of unspent resources. The fund balances of local boards of education are reported as part of their annual audits.

Not all fund balances can be considered spendable reserves; as a result, this report focuses on unassigned fund balances of local boards of education. Fund balances can be encumbered or unencumbered.

- Encumbered funds represent expenditures that have been planned, obliged, or restricted for a specific purpose.
- Unencumbered funds represent resources that do not have prior obligations, and as a result only unencumbered funds represent reserves of unspent resources.

The Governmental Accounting Standards Board's (GASB) Statement No. 54 classifies fund balances based on the extent to which a government is bound to observe constraints imposed upon the use of the funds.¹⁸ Exhibit 14 shows which fund balance classifications are available for spending. Because only unassigned fund balances represent a reserve of unencumbered resources, this report focuses on unassigned fund balances of local boards of education.

¹⁸ GASB was established in 1984 as an independent, private-sector organization that establishes accounting and financial reporting standards for U.S. state and local governments that follow generally accepted accounting principles.

Exhibit 14

Only Unassigned Fund Balances are Unencumbered

Fund Balance Classification	Description	Expenditure Obligation Status
Non-spendable	Fund balance that is not spendable by its nature; created by long-term receivables, inventory, or the non-spendable corpus of a trust	Encumbered
Restricted	Funds on which constraints are placed externally by creditors, grantors, contributors, or laws of other governments or are imposed by law through enabling legislation or constitutional provisions	Encumbered
Committed	Funds to be used for specific purposes as dictated by formal action of the unit's governing body	Encumbered
Assigned	Amounts that are constrained by the government's intent but are neither restricted nor committed	Encumbered
Unassigned	Funds that do not fall into any of the other spendable categories	Unencumbered

Source: Program Evaluation Division based on GASB Statement No. 54.

A local board of education having a large fund balance can be problematic during the local budgeting process because it may lead to funding disagreements. There is no prohibition against a local board of education maintaining a fund balance, and boards of county commissioners may not force a local board of education to expend its fund balance for operations or capital. Furthermore, a local board of education is not required to return a portion or all of its fund balance to the county. However, a board of county commissioners may consider the fund balance available to the Local Education Agency (LEA) when making annual budget determinations. Large fund balances can be problematic during the budgeting process because they may make boards of county commissioners reluctant to meet local board of education funding requests in the face of other financial demands.

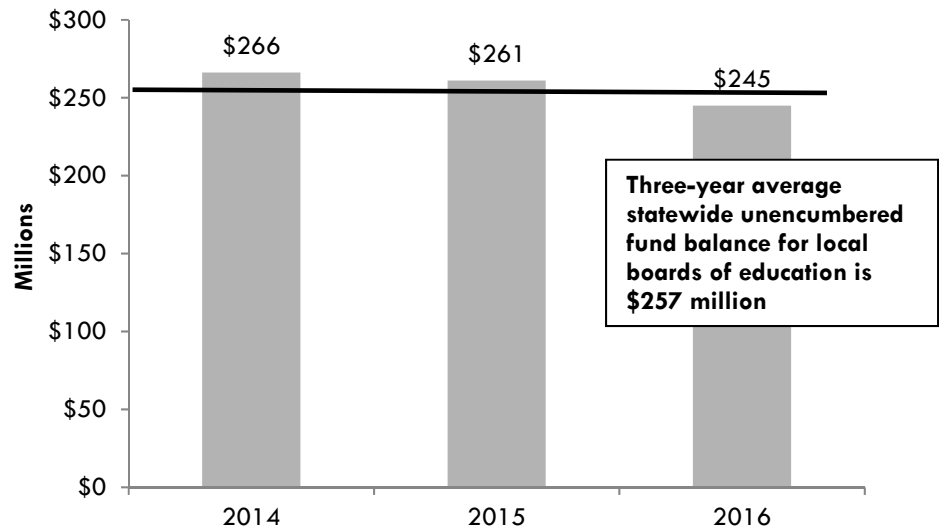
The Program Evaluation Division sought to determine the extent to which the fund balances of local boards of education affected the likelihood of local education funding disputes. However, due to policies regarding record retention, information on past local board of education fund balances was incomplete and insufficient to systematically determine their effect on funding disputes. Nevertheless, a survey of county commissioners and staff who have been through the dispute resolution process revealed that the majority (71%) believe the size of their local board of education's fund balance was a factor contributing to their funding dispute. Furthermore, interviews with subject matter experts confirmed that the existence of local board of education fund balances influences boards of county commissioners' appropriations decisions.

Between Fiscal Years 2013–14 and 2015–16, local boards of education collectively maintained, on average, in excess of \$250 million in unencumbered fund balances; this amount represents resources that were not invested in public K-12 education. Data on unencumbered fund balances of local boards of education are not centrally aggregated. As a result, the Program Evaluation Division obtained three years of audited

annual financial statements on each of the 115 local boards of education and manually extracted fund balance data. Exhibit 15 shows the total annual unencumbered fund balance for local boards of education for Fiscal Years 2013–14 to 2015–16. Although unencumbered fund balances are shrinking, the three-year average statewide unencumbered fund balance for local boards of education exceeds \$250 million.

Exhibit 15

Three-Year Average
Statewide Unencumbered
Fund Balance For Local
Boards of Education
Exceeds \$250 Million



Note: The total for 2016 reflects unencumbered fund balances for 102 local boards of education because not all audited financial statements were available at the time of analysis.

Source: Program Evaluation Division based on data from 115 local boards of education's audited annual financial statements, which were obtained from the Local Government Commission.

To further illustrate the magnitude of fund balances, the Program Evaluation Division analyzed local board of education fund balances in terms of the amount per student across LEAs for Fiscal Year 2015–16. On average, local boards of education maintained \$319 per student in unencumbered fund balances. A total of 24 local boards of education maintained \$500 or more per student in unencumbered fund balances. The amount of unencumbered fund balance in one LEA was \$1,244 per student.

Individual local board of education unencumbered fund balances vary widely across LEAs. To compare the magnitude of unencumbered fund balances across local boards of education, it is necessary to examine the unencumbered fund balance as a percentage of general fund expenditures, which is referred to as the unencumbered fund balance ratio. Exhibit 16 shows the variation across local boards of education in unencumbered fund balances as a percentage of general fund expenditures. Although the three-year average ratio is 20%, some local boards of education far exceed the average, with one LEA's unencumbered fund balance reaching 82% of general fund expenditures in Fiscal Year 2014–15.

Exhibit 16

Unencumbered Fund Balance Ratios Vary Widely Across Local Boards of Education

Fiscal Year	Local Boards of Education's Unencumbered Fund Balance Ratios		
	Minimum	Mean	Maximum
2013–14	0%	20%	77%
2014–15	0%	21%	82%
2015–16	0%	19%	70%
Three-year average	0%	20%	76%

Source: Program Evaluation Division based on data from 115 local board of education audited annual financial statements, which were obtained from the Local Government Commission.

Although local boards of education are units of local government, they do not have the same operational needs as counties to justify carrying large unencumbered fund balances. Units of government with taxation authority need to maintain fund balances for several operational reasons that include

- meeting cash flow needs,
- avoiding challenges of the tax collection cycle,
- maintaining reserves for emergencies and other unforeseen events,
- increasing investment income, and
- protecting credit ratings.

The Local Government Commission (LGC) is charged with monitoring the fiscal health of local governments and offering guidance in financial administration. The LGC provides guidance on fund balances for local governments with taxation authority. The purpose of this guidance is to protect a local government's credit rating and maintain its long-term solvency. The LGC recommends that a tax-levying unit of government maintain a sufficient unencumbered fund balance, which they define as being at least 8% of a local government's general fund expenditures.

Because local boards of education do not have taxing authority, the LGC has not issued guidance on their fund balance levels. In interviews with the Program Evaluation Division, LGC staff stated that local boards of education may not need large unencumbered fund balances because LEAs do not have the same operational needs as counties.

To further explore fund balance levels, the Program Evaluation Division compared fund balances across counties and local boards of education. Exhibit 17 shows the three-year average unencumbered fund balance ratio for counties (23%) is similar to that of local boards of education (20%), even though counties are responsible for far more governmental functions than local boards of education. Furthermore, the three-year average maximum unencumbered fund balance ratio is actually lower for counties (62%) than for local boards of education (76%). In each fiscal year analyzed, there were at least 30 local boards of education with unencumbered fund balance ratios that exceeded their county's ratios.

Exhibit 17

Several Local Board of Education Unencumbered Fund Balance Ratios Exceed Their County's Ratio

Fiscal Year	County Mean Unencumbered Fund Balance Ratio	County Maximum Unencumbered Fund Balance Ratio	Number of Local Boards of Education with an Unencumbered Fund Balance Ratio that Exceeds Their County's Ratio
2013–14	24%	63%	43
2014–15	24%	67%	43
2015–16	21%	56%	30
Three-year average	23%	62%	N/A

Source: Program Evaluation Division based on data from 115 local boards of education's audited annual financial statements, which were obtained from the Local Government Commission.

Exhibit 18 shows how the operational needs of units of local government with taxation authority to maintain large unencumbered fund balances do not apply to local boards of education. During interviews, LGC staff stated that local boards of education could need as little as one month's worth of general fund expenditures in unencumbered fund balances. In Fiscal Year 2015–16, more than half of local boards of education (64%) maintained more than one month of general fund expenditures in unencumbered fund balances.¹⁹ Establishing guidance that sets a maximum unencumbered fund balance for local boards of education could help ensure these boards are maximizing investment of local resources in public K-12 education and could minimize the use of the dispute resolution process when ample reserves exist.

In summary, local boards of education having large unencumbered fund balances can be problematic during the local education budgeting process because it may lead to funding disagreements. The majority of respondents to a survey of county commissioners and staff who have been through the dispute resolution process believe the size of their local board of education's fund balance was a factor contributing to their funding dispute. The Program Evaluation Division determined that, between Fiscal Years 2013–14 and 2015–16, local boards of education collectively maintained, on average, in excess of \$250 million in unencumbered fund balances annually. Not only do local boards of education not have the operational needs to justify carrying large unencumbered fund balances, but these balances represent local resources that are not being invested in public K-12 education.

¹⁹ These figures assume a 10-month operating cycle for local boards of education.

Exhibit 18: Local Boards of Education Do Not Have the Operational Needs that Would Require Maintaining Large Unencumbered Fund Balances

Operational Need for Maintaining Large Unencumbered Fund Balance	Local Board of Education Has Operational Need	Rationale Regarding Existence of Operational Need or Not
Meeting cash flow needs	●	The majority of operational funding comes from state allotments, and resources become available as expended. Furthermore, because N.C. Gen. Stat. § 159-27(a) dictates that school revenue that comes from the collection of local taxes is distributed on at least a monthly basis, cash flow needs are limited.
Avoiding challenges of the tax collection cycle	○	Local boards of education are non-tax collection units of government. Furthermore, school revenue that comes from the collection of local taxes by counties is distributed monthly per N.C. Gen. Stat. § 159-27(a) and is not subject to the challenges of the tax collection cycle.
Maintaining reserves for emergencies and other unforeseen events	●	LEAs are subject to emergencies and other unforeseen events. Fund balances are useful in offsetting cuts in state funding. However, given that counties are charged with the statutory authority for appropriating local resources for K-12 public education, it is reasonable to assume counties serve as the source of reserves for LEA emergencies. Nevertheless, a local board of education's reliance on its county for reserves to address emergencies and other unforeseen events could be challenged by poor working relationships.
Increasing investment income	○	Local board of education investment authority is limited to the instruments described in N.C. Gen. Stat. § 115C-443 and capital.
Protecting credit ratings	○	Local boards of education do not have the authority to issue debt and, as a result, do not need reserves to preserve credit ratings.
<p style="text-align: center;"> No Operational Need Exists = ○ Some Operational Need Exists = ● Operational Need Exists = ● </p>		

Source: Program Evaluation Division based on review of statute, literature, and interviews with Local Government Commission staff.

Recommendations

Recommendation 1. If the General Assembly wants to eliminate litigation from the local education funding dispute process, then the General Assembly should revise state law for settling local education funding disputes to preserve the benefits of the pre-litigation phase while replacing the litigation process with a default funding mechanism.

As discussed in Findings 1 through 3, the local education dispute resolution process is used infrequently and seldom results in litigation. The pre-litigation stages of the process (joint meeting and formal mediation) can produce non-financial outcomes that improve the local education budgeting and finance environment. However, the litigation stages are costly and time-consuming, and leave both boards of county commissioners and local boards of education short of needed resources.

In Finding 4, the Program Evaluation Division found that Tennessee, which like North Carolina has elected school boards that are fiscally dependent on county commissioners, offers an alternative method for settling local education funding disputes. In lieu of litigation, local education funding disputes in Tennessee are settled using a statutorily prescribed default funding mechanism.

Building on the Tennessee concept of a default funding mechanism, the Program Evaluation Division has created one tailored to North Carolina. This default funding mechanism would allow the General Assembly to eliminate the litigation phase of the dispute resolution process while preserving the benefits of the joint meeting and formal mediation stages.

The default funding mechanism is not meant to determine the appropriate level of local funding for operations and capital, but rather should act as a deterrent discouraging failure to come to a resolution through the annual budget process. Stakeholders have expressed concerns that capital appropriations to local boards of education may vary from year to year and have advocated for exempting capital appropriations from the default funding mechanism. However, exempting capital appropriations would negate the purpose of the default funding mechanism serving as a deterrent for failure to come to a resolution when capital appropriations are at issue.

This proposal preserves state law directing the joint meeting and formal mediation stages of the dispute resolution process before triggering a default funding mechanism. As currently prescribed by state law, the board of county commissioners and local board of education would still be required to arrange a joint meeting to negotiate an agreement. If no agreement is reached during the joint meeting, both boards would engage in formal mediation, sharing the costs equally, to resolve the funding dispute. If the board of county commissioners and local board of education cannot resolve their funding dispute during the joint meeting or through formal mediation, the default funding mechanism would be triggered.

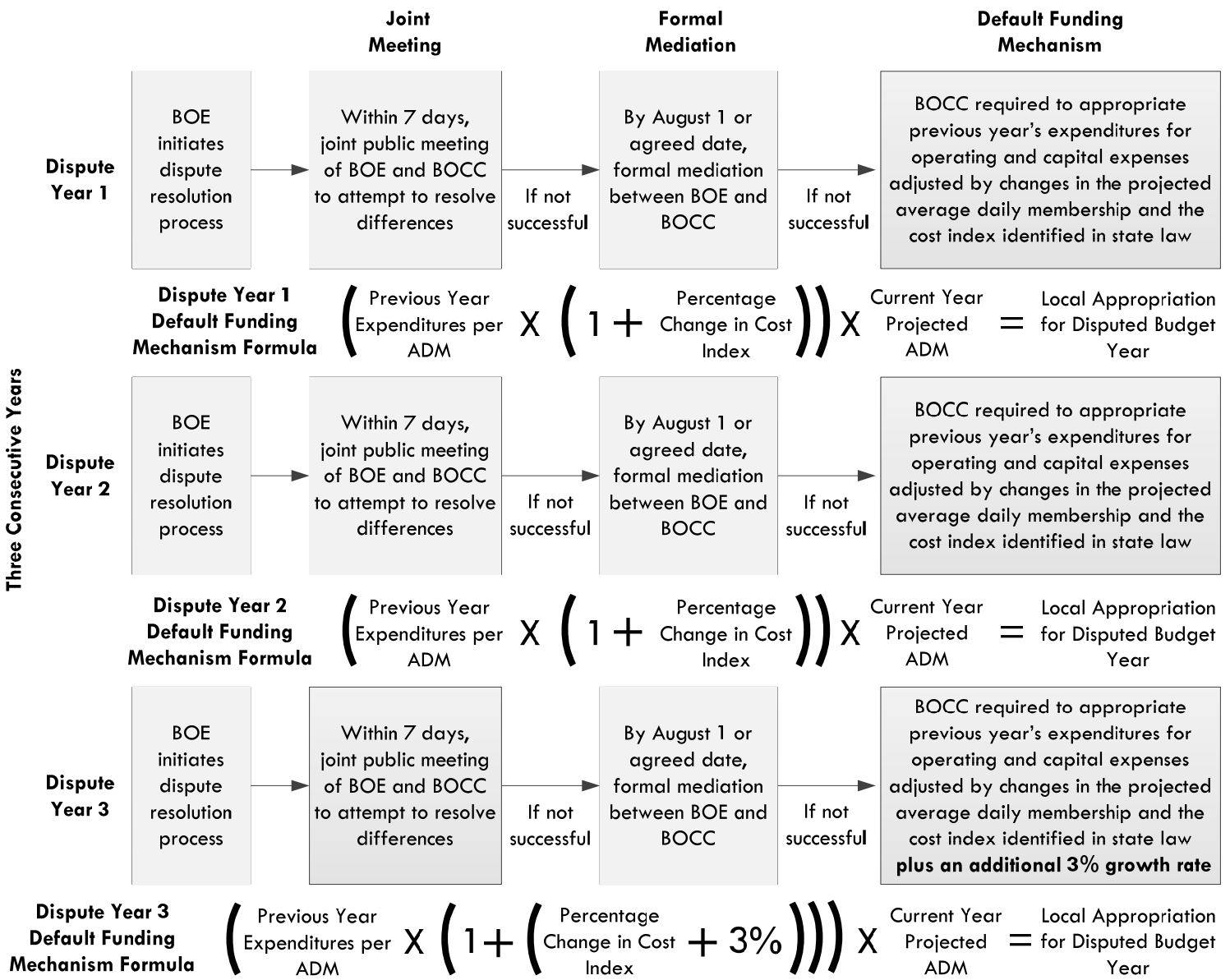
The default funding mechanism establishes a consecutive three-year framework for settling recurring local education funding disputes. The board of county commissioners would appropriate local education funds as determined by the default funding mechanism once it has been triggered. Under the default funding mechanism, local appropriations for the first

disputed budget year would be the previous year's expenditures for operating and capital expenses adjusted by changes in the projected average daily membership (ADM) for the Local Education Agency (LEA) and changes in an employment cost index of salaries and wages for elementary and secondary school personnel.²⁰ If a funding dispute cannot be resolved during the second consecutive budget year, the default funding mechanism described previously would again determine the local appropriation for education. If a funding dispute cannot be resolved during a third consecutive budget year, the default funding mechanism adds an additional 3% growth rate to the mechanism used during the previous two years.

Exhibit 19 provides a diagram and a hypothetical example illustrating how the default funding mechanism works if funding disputes occur during three consecutive budget years. If funding disputes occur during non-consecutive budget years, the default funding mechanism would restart each time. If funding disputes between the two boards continue to occur after the initial three-year time period, the default funding mechanism process would restart and cycle through the three-year time period until such time that the boards can settle their funding disputes without resorting to the default funding mechanism.

²⁰ This cost index was chosen because the majority of public education expenditures are for personnel salary and benefits. The cost index (Bureau of Labor Statistics' Employment Cost Index Series Id: CIU3026100000001) is reported quarterly for a calendar year, and second quarter data would be the most recent data available during the local education funding dispute resolution process.

Exhibit 19: Revised Dispute Resolution Process Replaces Litigation with a Default Funding Mechanism



Hypothetical Example	Base Year	Dispute Year 1	Dispute Year 2	Dispute Year 3
	Fiscal Year 2013–14	Fiscal Year 2013–14	Fiscal Year 2013–14	Fiscal Year 2013–14
Projected Average Daily Membership (ADM)	1,000	1,013	1,042	1,071
Cost Index Percentage Change	N/A	0.95%	1.89%	1.52% + 3.0%
Local Operational Expenditures per ADM	\$ 100	\$ 100.95	\$ 102.86	\$ 107.51
Total Local Expenditures	\$ 100,000	\$ 102,266	\$ 107,180	\$ 115,138

Notes: BOCC stands for board of county commissioners. BOE stands for local board of education. For the hypothetical example, the Program Evaluation Division used the Bureau of Labor Statistics' Employment Cost Index for elementary and secondary school workers for calendar years 2012 through 2016 (Series Id: CIU302610000001). This cost index is reported quarterly for a calendar year, and second quarter data would be the most recent data available during the local education funding dispute resolution process. To calculate the Cost Index Percentage Change for each disputed budget year, the second quarter cost index data from the previous calendar year was compared it to the second quarter data for the current year.

Source: Program Evaluation Division.

Recommendation 2. The General Assembly should direct the Local Government Commission and School of Government at the University of North Carolina at Chapel Hill to convene a working group to develop and recommend statutory parameters for fund balances maintained by local boards of education.

As discussed in Finding 5, many local boards of education are retaining large unencumbered fund balances. Fund balances can be an issue in disagreements between local boards of education and boards of county commissioners but also represent resources being withheld from K-12 public education. Local boards of education do not need to maintain large unencumbered fund balances because their operational needs are different from county governments and the majority of their operational funding comes from state appropriations. The Local Government Commission (LGC) does not currently provide guidance for local boards of education because these boards are not authorized to levy taxes.

To address unencumbered fund balances maintained by local boards of education, the General Assembly should direct the LGC and the School of Government (SOG) at the University of North Carolina at Chapel Hill to develop and recommend statutory parameters for fund balances maintained by local boards of education. The working group should include representatives from the North Carolina Association of County Commissioners, North Carolina School Board Association, and North Carolina Association of School Business Officers. The parameters should provide direction for local boards of education on

- minimum and maximum fund balances with a focus on unencumbered funds,
- appropriate uses of fund balances,
- annual reporting requirements of fund balances,
- how fund balances should be factored into annual local budgets for education, and
- the role of boards of county commissioners in determining the use of fund balances maintained by local boards of education.

The working group should recommend statutory parameters for local board of education fund balances to the Joint Legislative Education Oversight Committee no later than March 30, 2018.

Appendix

Appendix: Judicial Decisions Relating to the Local Education Funding Dispute Resolution Process

Agency Response

A draft of this report was submitted to the North Carolina School Boards Association and the North Carolina Association of County Commissioners. Their responses are provided following the appendix.

Program Evaluation Division Contact and Acknowledgments

For more information on this report, please contact the lead evaluator, Sean Hamel, at sean.hamel@ncleg.net.

Staff members who made key contributions to this report include Brent Lucas. John W. Turcotte is the director of the Program Evaluation Division.

Appendix: Judicial Decisions Relating to the Local Education Funding Dispute Resolution Process

This appendix describes several judicial cases relevant to the local education funding dispute resolution process.

Leandro v. State¹

In the 1997 *Leandro v. State* case, the court addressed the definition of a sound and basic education. The North Carolina Supreme Court defined a sound and basic education as one that ensures each student the opportunity to obtain the following: ability to read, write, and speak the English language and fundamental knowledge of mathematics and physical sciences; fundamental knowledge of geography, history, and basic economic and political systems to enable the student to make informed decisions with regard to issues that affect the student and his or her community, state, and nation; academic and vocational skills to successfully engage in post-secondary education and training; and academic and vocational skills to compete with others in further formal education or gainful employment in a contemporary society.

The *Leandro* decision guarantees each and every child the right to an equal opportunity to obtain a sound basic education, which requires that each child be afforded the opportunity to attend a school that has, at a minimum, the following educational resources.

- Every classroom must be staffed with a competent, certified, well-trained teacher able to teach the standard course of study by implementing effective education methods that provide differentiated, individualized instruction, assessment, and remediation to the students in a classroom.
- Every school must be led by a well-trained, competent principal with the leadership skills and ability to hire and retain competent, certified, and well-trained teachers who can implement an effective and cost-effective instructional program that meets the needs of at-risk children so that they can have an equal opportunity to obtain a sound basic education by achieving grade level or above academic performance.
- Every school must be provided, in the most cost-effective manner, the resources necessary to support an effective instructional program within that school so that all children, including at-risk children, have an equal opportunity to obtain a sound basic education.

Beaufort County Board of Education v. Beaufort County Board of Commissioners²

In *Beaufort County Board of Education v. Beaufort County Board of Commissioners*, the court addressed a funding dispute between these two boards that arose during Fiscal Year 2006–07. The board of education requested \$12.1 million, and the board of county commissioners allocated \$9.4 million. After complying with the joint meeting and mediation stages of the dispute resolution process, the board of education engaged in Stage 3 (Superior Court Trial). A jury found the board of education needed \$10.2 million for Fiscal Year 2006–07 for school operations and required the board of county commissioners to appropriate that amount.

The board of county commissioners then engaged in Stage 4 (Appellate Review). Ultimately, the North Carolina Supreme Court found no error in the initial judgment amount. The court's rationale was based on its interpretation of N.C. Gen. Stat. § 115C-426, holding that statute clearly envisions that some funding for operations come from local governments because it establishes the local current expense fund. The court affirmed three important holdings:

- the statute establishing the dispute resolution process does not delegate to the courts the Legislature's constitutional duty to provide for a "general and uniform system of free public schools";
- a court cannot require a county to provide more than the minimum level of educational funding required by state law, which is interpreted as the amount necessary for a system of public schools that provides students the opportunity for a sound basic education; and
- a county's funding responsibility for its local board of education is not limited to capital outlay.

¹ 488 S.E.2d 249 (1997).

² 681 S.E.2d 279 (2009).

Union County Board of Education v. Union County Board of Commissioners³

In *Union County Board of Education v. Union County Board of Commissioners*, the courts addressed a funding dispute between these two boards during Fiscal Year 2013–14. During this time, the board of education had requested \$86.2 million for operating expenses and \$8.4 million for capital outlay from the board of county commissioners. The board of county commissioners appropriated \$82.3 million for operating expenses and \$3 million for capital outlay, \$9.2 million less than board of education’s request. The board of education believed this amount to be inadequate and entered into the dispute resolution process. The initial joint meeting and mediation phases passed without resolution, and in August 2013, the board of education engaged in Stage 3 (Superior Court Trial).

A Superior Court jury found the board of education had established evidence of the cumulative effect of funding shortfalls over several years, and the judge ordered the jury to determine the amount of funding from all sources, specifying the local government’s share, that is necessary to “maintain a system of free public schools as defined by State law and State Board of Education policy.” The jury awarded an additional \$5 million for operating expenses and \$86 million for capital outlay beyond the amounts already appropriated by the board of county commissioners.⁴ The court ordered the board of county commissioners to pay this amount to the board of education and authorized the levy of additional taxes if needed to sufficiently cover the costs.

The board of county commissioners appealed the Superior Court’s decision because it believed that 1) the trial court erred in allowing an argument of improper legal standing in the opening statement, and 2) the trial court allowed evidence regarding the cumulative effect of underfunding. In granting a new trial, the North Carolina Court of Appeals affirmed that

- the dispute resolution process concerned a single year’s funding needs, and as a result the introduction of evidence establishing cumulative deficiencies was not permissible; and
- a county’s funding responsibility for operating expenses and capital outlay only applies to what is legally “necessary” for the school district to meet its constitutional obligation of providing students the opportunity to receive a sound basic education.

³ No. COA14-633 (2015).

⁴ The amount awarded by the jury represented nearly \$82 million more than the board of education had requested for the 2012–13 fiscal year.



Leanne E. Winner
Director of Governmental Relations

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May 16, 2017

John W. Turcotte, Director
Program Evaluation Division
300 N. Salisbury Street, Suite 100
Raleigh, NC 27603-5925

Dear Mr. Turcotte:

Thank you for providing the North Carolina School Boards Association (NCSBA) the opportunity to respond to the Program Evaluation Division's report on *Local Education Funding Dispute Resolution Process is Effective and Economical, but Litigation Could be Eliminated*.

The local education funding dispute resolution process has been a contentious issue in the General Assembly. NCSBA hopes that this report will provide a clear path for the General Assembly to provide resolution to this issue that is agreeable to school boards and county commissioners.

Recommendation 1, to eliminate the potential of a lawsuit after mediation and replace it with a funding formula, would still provide relief for school boards, and the students they serve, without spending large sums of taxpayer dollars on attorneys' fees or tying up the judicial system. The funding formula presented in the report is one that we believe adequately provides enough impetus for county commissioners to negotiate during the mediation step in good faith and would in most circumstances provide adequate relief if the mediation was not successful. One instance that we do not believe the funding formula adequately addresses is when capital improvements are needed to address non-compliance with federal or state regulations like ADA. The cost of these could very well exceed the formula because many times these issues have developed after a large number of years of inadequate capital funding.

As cited in the report, we do believe it is important for the mediation stage to stay intact. In many instances the resolution of the immediate funding issue may open a new line of communication and understanding between the two bodies.



Leanne E. Winner
Director of Governmental Relations

Recommendation 2 suggests that a recommendation be made on statutory parameters for fund balances maintained by local boards of education. NCSBA believes that this recommendation is excessive. We believe the working group should examine whether there should be statutory parameters placed on LEA fund balances. While the data is available in audits, NCSBA was not able to examine the data in the timeframe that was given to respond to this report. If we had been able to examine the data, we would have likely reached out to some of the districts that maintained high fund balances to find out why they were being maintained at that level and if the county commissioners knew and were supportive of them being maintained at the level.

Also, the report states that because school boards do not have taxing authority, like 90 percent of their counterparts across the county, fund balances should not be held at such a high level. In our opinion the opposite it is true. When a governmental entity has no ability to generate its own funds, it is imperative that they have a robust rainy day fund. This would allow the entity to address emergencies or revenue declines due to economic downturns. Since personnel costs account for approximately 90% of a school system budget, without a strong reserve for economic downturns, school systems would be forced to reduce staff. As one of if not the largest employer in the county, this could have substantial impact on the local economy.

Additionally, many years the state budget is not approved until right before school starts and in some instances the state budget is not approved until the school year has begun. Almost always, there are surprise budget implications for the school district budget that had not been anticipated. A strong fund balance allows districts to be able to mitigate these unanticipated budget changes.

Thank you again for the opportunity to respond to the report.

Sincerely,

Leanne E. Winner
Director of Governmental Relations
North Carolina School Boards Association



May 15, 2017

Mr. John W. Turcotte, Director
North Carolina General Assembly
Program Evaluation Division
300 North Salisbury Street, Suite 100
Raleigh, North Carolina 27603

Dear Mr. Turcotte,

Thank you for the opportunity to respond to the “Local Education Funding Dispute Resolution Process is Effective and Economical, but Litigation could be Eliminated” Program Evaluation Division report. The evaluation is thorough, and we appreciate the comprehensive examination of data and context included in the process, as well as the consistent communication and open discussion with PED staff.

The report highlights many of the concerns about the lawsuit mechanism portion of the dispute resolution process raised by the membership of the N.C. Association of County Commissioners over the years. While the mediation process creates potential opportunities for relationship-building and dialogue, these same opportunities do not exist through permitting local boards of education to sue with the resulting expenses for litigation diverted from education and other county needs. However, Finding 1 that litigation has been necessary on only four occasions does not acknowledge the situations when counties have chosen to end the process at mediation simply to avoid costly and time-consuming litigation, not because they feel the parties have reached a successful outcome.

The association supports the recommendation to develop parameters around recommended fund balance levels for boards of education, as guidelines could provide both boards a starting point and framework during budget discussions.

The recommended default funding mechanism in cases of disagreement will also provide a tangible reference point for boards of education and county commissions during school funding discussions, and we support the approach in principle and practice. Our counties on the whole are currently providing more in local current expense (operating) funding each year, so the recommended calculation comports well with that actuality. Capital funding, however, is appropriated in different ways and through various formulas by our members, based on the number of school districts in a county, the number of capital projects that are needed in a given year, and other budgeting practices specific to a county. As a result, the same default calculation that applies suitably to operating funding



may not provide the same fit for capital appropriations. If a default funding mechanism is adopted, we would recommend applying the mechanism only to operating expenses, allowing some flexibility for capital funding based on particular annual needs in a district, or both.

Thank you again for this comprehensive evaluation. We know the membership of our local boards of education and county commissions are aligned in their goal to support students, teachers, and a strong public education system.

Sincerely,

Johanna H. Reese
Director of Government Relations