Three Perspectives on the Fiscal Outlook of Los Angeles Unified School District

Los Angeles Unified School District
*Independent Analysis Unit*

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This is one in a series of reports by the Independent Analysis Unit on budget-related topics.

The views expressed herein are those of the Independent Analysis Unit and do not necessarily reflect those of the District, the Board of Education, or any individual Board Member. Any views expressed about collective bargaining issues are suggestions by the Independent Analysis Unit for study and discussion, and should not be interpreted as reflective of the District’s position in any current negotiations.
EXECUTIVE SUMMARY

The fiscal condition of the Los Angeles Unified School District has been the subject of warnings and recommendations for decades. Much of the concern has focused on deficits in annual budgets including the three-year extension of those budgets. This focus, while required by governing agencies and standard practices, can lead to a misunderstanding of the real challenges facing the District.

Short-term budget deficits come and go, which may or may not reflect a fiscal problem, but definitely reflects a planning problem.

In the short term, the District has often shown a deficit in its annual budget, but has almost always resolved that deficit by the fiscal year’s end through a variety of steps including cuts to planned spending. If a multiyear projection of the budget indicates running out of available reserve funds by the end of the third year, the District is required to submit a Fiscal Stabilization Plan showing what cuts or other actions it can realistically take—and is willing to take if necessary—to avoid that three-year outcome.

Because of the Fiscal Stabilization Plan, it is incorrect to interpret the originally projected shortfall as an impending or likely scenario. However, the District will face fiscal disaster if it (a) fails to implement the Fiscal Stabilization Plan, or (b) allows fixed costs that cannot be modified on short notice to grow so large that they cannot be covered by unplanned cuts to other costs. There does not appear to be a great risk of failing to implement the Fiscal Stabilization Plan at present, although implementation depends on the Board and District staff having the discipline to carry out plans. But the risk of allowing fixed costs to rise is real and is a serious threat to the District’s ability to carry out an educational agenda. This risk requires action sooner rather than later.

The existence of repeated short-term budget deficits—even if they never materialize as actual deficits—reveals the need for better strategic financial planning. If it is going to be necessary to reduce expenditures, it is better to make strategic cuts with adequate preparation than to wait until it becomes necessary to take opportunistic cuts from the categories of spending that are most easily cut with short notice.

This report recommends that the District annually create a Long Term Strategic Financial Plan with a time horizon of five or six years. This would allow the required three-year Fiscal Stabilization Plan to serve its purpose as a contingency plan. It would also give the District an opportunity to make better long-term decisions and plans that would make execution of the opportunistic cuts in a Fiscal Stabilization Plan unnecessary.

Long-term trends are not sudden crises, but they are inevitable and serious challenges for the District.

Although per-student funding rates are likely to increase slightly over the next several years, projected declines in enrollment are likely to result in a gradual decline in revenue. Since expenditures cannot exceed revenue for any extended period of time, that means total expenditures must also decline. It is erroneous to think of expenditures rising far above revenues, as a simple extrapolation of current trends would suggest, because such an outcome is impossible.

The real long-term threat is that some spending categories will continue to rise even if cuts are made in other categories to balance expenditures with revenues. By far the largest contributor to expenditure growth has been the cost of benefits for employees and retirees. Pension costs are currently rising faster than other benefits because of hikes in the contribution rates required by the state, but in the event of major budget cuts requiring reductions in force those costs can also be reduced. On the other hand, health care costs for retirees will continue to grow long after any reductions in force bring other
costs under control. Over time, these costs will rise so much that they crowd out resources for all other purposes, forcing the District into unacceptably low spending on instruction.

This report recommends that the District focus on the ‘big numbers’, i.e., areas where the changes that can be made are large enough to make a difference in the long-term trends. If the size of the crowd-out problem is $2 billion dollars a year in ten years, then eliminating it would require 200 initiatives saving $10 million each, but only 5 initiatives saving $400 million each. Cost-cutting measures in areas without that much to cut will be useful and important, but simply will not offer enough savings to close the gap.

Some ways to focus on the big numbers include these:

Pursue game-changing public policy strategies. Three separate issues dominate the District’s long-term fiscal trends: funding per student, pension contribution rates, and health care costs. Changing policy in these areas would benefit L.A. Unified far out of proportion to the District’s efforts to bring about such change.

Control growth in major benefit costs. This is imperative for the District. There are many strategies toward this end, but it must be a higher priority than other kinds of budget cutting.

Build more flexibility into major contracts. When fiscal conditions are expected to remain stable, it is possible to save money by negotiating contracts at guaranteed terms over a period of time. However, when there is uncertainty about long-term fiscal stability, such contracts can prevent the District from adjusting its fixed costs as rapidly as needed. The flexibility to make decisions in the future with better information has a value—an option value—that the District should consider paying when negotiating contracts.

Avoid the big mistakes. Over the years, the District has earned a reputation for expensive project mismanagement. Such occurrences can set the District back both in budgetary terms and in the public support needed when asking for additional resources. In opportunistic cost-cutting, it is sometimes tempting to reduce staff levels to the point of ineffectiveness in critical cost-management areas such as planning, analysis, control, information, and monitoring. Such cuts can be self-defeating if they allow much bigger costs to go uncontrolled.

Even if the current budget projections were fully funded, the District would still be far short of achieving its mission. This is not a new situation; the District has long failed to achieve its educational goals while consuming all its resources.

In the focus on budget deficits, it is easy to forget that budgets are numerically and psychologically benchmarked to previous budgets, not to a vision and analysis of what resources would be required to accomplish the District’s mission. Resolving a budget deficit is a victory, but a small one compared to the magnitude of student need and missed opportunity. L.A. Unified is required to keep its expenditures within the revenues that it receives. However, it has an unconditional responsibility for the education of all students within its boundaries. This means the District has an obligation and an opportunity to find ways to accomplish more with less.

This report recommends that L.A. Unified seek ways to transform educational productivity—defined not as working harder, but as developing and using the tools/technology, organization/collaboration, practices/techniques, and human capital that will enable greater fulfillment of educational goals without increasing the net cost to the District.

All of these recommendations while challenging are doable. None of them alone will ‘solve’ the entangled puzzle that is the District’s fiscal outlook. However, each of them would make a major contribution to the fiscal health of L.A. Unified and therefore to the high quality and equitable education of all its students.
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SECTION ONE: INTRODUCTION

A deep analysis of the District’s financial situation is justified for several reasons:

- In 2015, the Independent Financial Review Panel announced that L.A. Unified “faces a structural deficit in its operating budget that threatens the District’s long-term viability.” (See Table 1 in Appendix A for a summary of their findings and recommendations). Similar studies are not new to the District (See Table 2 in Appendix A for a summary of findings and recommendations from a study done in 2004). One notable observation about these tables is that—while the District has implemented or started to implement several of these recommendations—there are other recommendations that remain untried or only weakly implemented.

- Over the last ten years, the District has frequently certified its financial reports to the Los Angeles County Office of Education (LACOE) as ‘qualified’, which means the statements do not meet one or more of the criteria for financial stability established by LACOE. The most important of these criteria is that the District must show a budget with three-year projections that do not indicate running out of reserve funds by the end of that period. If this is not the case, the District must present a Fiscal Stabilization Plan to make it so.

- The District’s reserve fund, which is required to be at least 1% of operating costs, and which District policy targets at 5%, is shrinking and can be projected to drop below 1% in two or three years at current rates of revenue and expenditures, depending on assumptions.

- In recent months, observers and advocacy groups outside the District have spoken of the District’s fiscal outlook using such phrases as ‘structural deficit’, ‘fiscal cliff’, ‘financial ruin’, and ‘staving off insolvency’. One writer pointed out that “L.A. Unified faces a budget deficit of $482 million by 2020.”

The way the Board chooses to address these challenges will define the success of the District in educating its students for many years to come.

In this context, the Independent Analysis Unit seeks to answer the following questions:

1. **What is the underlying nature of the District’s fiscal outlook in the short term?**
   - How real, how big, and how imminent is the deficit everyone talks about?
   - Is the fiscal survival of the District at risk, and under what conditions?
   - Are there problems in District management and budgeting that can be revealed by looking more deeply at the underlying dynamics of a fiscal crisis, and that can be solved or mitigated with concrete steps?

2. **What are the prospects for the District’s fiscal outlook in the long term?**
   - What trends appear most likely to dominate the District's long-term fiscal outlook?
   - What concrete steps will exert the greatest influence on these trends?

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3. What are the implications of these fiscal challenges for the mission of the District?

- Are there structural changes that would help close the gap between what the District seeks to accomplish for students and what it can afford?
- What other changes in education are necessary for the District to better fulfill its mission for students in the context of growing fiscal constraints?

The most frequent language used to describe the District’s fiscal situation is that it has or faces a structural deficit. The term deficit refers to a gap or imbalance such that expenditures exceed revenues. Since virtually every fiscal year ends without such a deficit, the statement that the District’s structural deficit represents a threat to the District’s viability requires closer examination.

Authorities differ on the definition of structural deficits. At its simplest, the term refers to an imbalance in an organization’s budget. A more complex definition distinguishes structural deficits from cyclical deficits. A structural deficit is a gap between revenues and expenditures that exists because of legal requirements, long-term contracts, political decisions, and other long-term factors, and not because of temporary or cyclical shocks to revenue or unexpected spikes in expenses that characterize cyclical deficits. Temporary deficits, even those that occur frequently, are called cyclical deficits.

Rather than adopting a single definition, this report discusses three ways of understanding fiscal deficits or the threat of deficits, corresponding to the three questions listed above:

**The Short-Term Budgeting Perspective** examines repeated short-term budget imbalances that force suboptimal mid-year changes and represent unfulfilled plans.

**The Long-Term Trend Perspective** examines adverse long-term trends in revenues and expenditures.

**The Mission Deficit Perspective** examines the challenge of meeting the educational needs of students and the community in the face of continuing budget constraints, now and into the long-term.

Each of these perspectives on the District’s budget implies recommendations, which are discussed in the following sections of this report.

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**Explanation of the Financial Assumptions in this Report**

Making assertions about the financial status of the District is shooting at a moving target. The FY 2018 third interim report and the FY 2019 budget are being released at about the same time as the finished version of this report. Thus, the assumptions used in this report are necessarily out of date. Updating the numbers would delay release of the report, by which time the FY 2018 unaudited actuals report might be available to justify further updating. Instead of chasing updates, the IAU has based this report primarily on the FY 2017 unaudited actuals and the FY 2018 adopted budget, with some updates through the FY 2018 second interim report or the FY 2019 adopted budget. Exceptions are noted in place.

As a public agency, the District is bound by law, regulation, and generally accepted practices to use fund accounting, *i.e.*, to keep separate accounts of certain categories of funds such as capital project funds, cafeteria funds, and fiduciary funds. Excluding such funds, the bulk of the District's operating costs are accounted for in the General Fund. *This report focuses exclusively on the General Fund*, which is the place that operating deficits and surpluses will appear.

The state's fiscal outlook and the District's budget projections appear more optimistic today than they did a year ago. While this may temporarily alleviate the short-term budgeting problem (the first of our three perspectives), it does not weaken the importance of addressing the issues in this report. The financial details are constantly changing, but the IAU believes that the fundamental realities described in this report remain valid, and that the recommendations remain justified.

**A Note about the Recommendations in this Report**

In the following discussion of recommendations, it may be useful to keep the following points in mind:

- *The District is already doing, planning, or considering many of these recommendations to some degree*, though perhaps not as fully as described here. Rather than catalog all these initiatives and their current stage of implementation, we present the recommendations on their own merits. Cataloging the District’s initiatives and their current state of implementation would be a worthwhile project, either for the IAU or for the Superintendent’s staff. One of the management challenges of this District is the degree to which functions and initiatives are siloed such that it is very difficult for anyone to be aware of them all.

- *This report does not constitute a fully researched and developed proposal for any of these initiatives*. What this report recommends is that the District study these suggestions, evaluate practices of other districts and organizations, consider potential costs and benefits, and engage in thoughtful dialogue with stakeholders before committing to any specific course of action.

- *Some of these recommendations may not be consistent with current regulations, contracts, and/or collective bargaining agreements*. Rather than dismiss them for that reason, we suggest considering them for future implementation. If they appear promising, the District could engage in long-term discussions about possible changes to agreements and strategies to influence and change regulations.
SECTION TWO: THE SHORT-TERM BUDGETING PERSPECTIVE

This section discusses the District's budget deficits as short-term phenomena that represent a planning problem more than a fiscal problem. It starts by pointing out the contrast between budgeted deficits and actual deficits, then the difference between projections and forecasts. Then it discusses the roles of some of the mechanisms and practices that characterize the budgeting process, and describes the short-term consequence as more of a planning problem than a fiscal problem. The section concludes with a recommendation that the District produce a long-term strategic financial plan, with a discussion of what that means and some of the features that distinguish it from other types of budget documents.

*It is important to note that this section is not a critique of the Budget Services office or staff, but a critique of the larger system in which they work, the District as a system.*

**Budget Deficits or Actual Deficits?**

In recent years, the annual budget adopted by the District at the beginning of each fiscal year has shown planned expenditures in excess of expected revenues. Figure 1 illustrates this trend, with historical budgets as adopted from FY 2009 through FY 2018. In this figure, it appears that FY 2010 and 2016 are the only budget years out of the past ten without a deficit.

![Figure 1. General Fund Budgeted Revenue and Expenditures, FY 2009 – FY 2018](source)

On the other hand, the actual financial statements at the end of each fiscal year tell a different story, as shown in Figure 2. In the actual reports, only FY 2010, 2012, and 2013 showed revenues below expenditures. In every other year shown in the figure, revenues were sufficient to cover actual costs.
What changes occur to convert a budgeted deficit into balanced year-end actuals? It’s not revenue, which has tended to be close to its budgeted amount, as shown in Figure 3. In part, this is because the largest component of revenue since 2013 has been the state’s Local Control Funding Formula, which is relatively stable and predictable. Under this formula, the amount funded per Average Daily Attendance (ADA), adjusted for targeted student populations (TSP), is known before the start of the fiscal year, while the ADA and proportion of students in TSP can be predicted within a reasonable margin of error.

In contrast to revenue, actual expenditures have tended, in most years, to be lower than their budgeted amount, as shown in Figure 4. As a result, a budget in which expenditures exceed revenues, i.e., a budget deficit, is typically transformed into an actual year-end statement in which expenditures do not exceed...
revenues, *i.e.*, balanced books. In nearly all years, an imbalance in the budget at the beginning of the year is resolved—and the deficit disappears—by the end of the year.

**Figure 4. General Fund Budgeted and Actual Expenditures, FY 2009 – FY 2018**

![Graph showing budgeted and actual expenditures from FY 2009 to FY 2018.](image)


Note: This graph is identical to the budgeted expenditure plot in Figure 1 and the actual expenditure plot in Figure 2.

This phenomenon of repeated budget deficits that do not materialize as actual deficits has a long history. From some angles, it might seem to be a good thing. However, it can make the District appear to be crying ‘wolf’, reducing its credibility when facing a genuine threat of actual deficits. And as we show below, it contributes to suboptimal planning over the long term.

The simplest explanation for this phenomenon is that the books are always balanced because the District has a policy requiring that to be the case. However, this is an unsatisfying answer. There are two primary mechanisms used to force the budget to balance at year end. The first draws on various available funds besides revenue, which shifts funding between years in a way that is sometimes unclear to the public, and/or entails an undesirable reduction in the District’s reserve. The second mechanism is to cut spending during the year, so that actual expenditures end up lower than budgeted expenditures. Each of these mechanisms raises important concerns that will be discussed in this section.

**Projections or Forecasts?**

Much of the discussion about the District’s fiscal situation centers on projections of budget deficits over the next two to three years. Difficulties arise because different people use different projections and different interpretations of those projections. Part of the problem lies in a misunderstanding of the difference between *projections* and *forecasts*. In particular, some of the rhetoric surrounding the deficit issue has focused on one conditional projection and treated it as an almost inevitable forecast.

Both of these terms and the methods they define are useful in fields ranging from financial management to energy to sports, and of course they are used in school district budgeting. L.A. Unified produces a wide variety of projections and forecasts for different purposes, such as the E-CAST of enrollments. However, in
interpreting the District’s budget documents, it is important not to conflate the two terms: while a forecast is a specific kind of projection, not all projections are forecasts.

*Projections* start with a reference point such as the current budget, and present what it would look like in the future if current trends continue, or given certain other assumptions about income, expenditures and external factors. On the other hand, a *forecast* is one specific kind of projection — a highly likely one, given everything known to be true and expected to happen with high probabilities of actually occurring.

The difference between a projection and a forecast is illustrated in Figure 5. An airplane that is pointed at the ground may be *projected* to crash, but if the pilot (or automatic landing system) does their job as expected, the airplane can be *forecasted* to level off into a smooth landing. The forecast might be wrong, because of pilot error or other incorrect assumptions. But the projection shown is almost certainly wrong because it ignores expected inputs. The projection is important, not because it shows what will happen, but because it provides critical information to be used in applying the right inputs to control what happens. To be more specific, when the District adopts a budget with a predicted future deficit, and simultaneously adopts a plan to mitigate that deficit, the correct forecast is the mitigated outcome, not the original deficit.

*Figure 5. Illustration of Projection versus Forecast*

All projections reflect scenarios, which are simply groups of assumptions, combined to represent possible future states. A *worst-case budget scenario*, for instance, might assume a recession and cuts to education funding, as well as higher-than-expected expenditures. The projections that follow would probably show a deficit. A *best-case scenario*, on the other hand, might assume a revenue windfall and unexpected cost savings. These assumptions could lead to a projection of surplus. Both scenarios and their respective projections are helpful in planning for a range of possibilities. Neither projection would be a forecast, however, because the most likely outcome falls between the extremes.

Every year, as part of its budget reporting procedures, the District makes *multイヤer projections* (MYPs), which are models of what might happen with revenues and expenditures given certain assumptions and calculations. The MYPs are developed using the SACS Form MYP, which Local Education Agencies (LEAs) across California complete to comply with statutory accounting requirements. State and county offices of education use these MYPs to help determine the financial health of their school districts.

On the revenue side, the District makes assumptions about levels of enrollment and attendance, the cost of living adjustment, LCFF grant amounts, and income expected from other sources. In general, the revenue estimates are accurate and reliable due to the formulaic nature of the money L.A. Unified gets from the state, the *Principal Apportionment*. The District assumes it will receive the prescribed amount and nothing

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4 California Education Code 42127.
extra, which is sound financial management and means that any amount the District may receive over expectations from unexpected or semi-expected sources comes as a pleasant surprise.

On the expenditure side, the MYP assumptions include projected spending on salaries and other expenses, a minimum reserve amount, an indirect cost rate, and amounts of money the District places in ending balances assigned for designated and undesignated purposes. In general, these spending assumptions are liberal, which makes sense. The District uses maximized expenditure assumptions because it wants to be sure it has the cash it needs to pay for all budgeted services and activities.

The MYPs are based on reasonable assumptions: the best currently available information on reliable sources of revenue and current decisions about next year’s spending. Planning for this scenario serves two purposes: it ensures compliance with state and county regulations, and it keeps day-to-day expenditures in check. When decision makers are aware that planned spending exceeds the minimum reliable revenue, they may think twice before ordering extra supplies or delay bringing on extra staff until absolutely needed. The MYPs help keep the District’s belt tight.

But the minimum-reliable revenue/highest-planned expenditure scenario is not the most likely scenario, and therefore any resulting projections are not forecasts. To make a forecast, two additional facts should be considered:

First, the County Office of Education carefully monitors the District financial health and requires a Fiscal Stability Plan, which ensures against insolvency. Whenever MYPs show running out of reserves within three years, the District adopts a Fiscal Stabilization Plan identifying additional cuts to avoid such an outcome. Those planned cuts should be considered as part of a forecast.

Second, the District typically spends less than it budgets to spend every year; the budgeted expenditures are higher than the expenditures in the unaudited actuals in most of the last 10 years, as shown in Figure 4. Such midyear cuts from the budgeted level of expenditures might not result in an optimal use of limited resources. As long as they are available, though, they represent adjustments that help turn a projected shortfall into a small forecasted surplus.

The Multiyear Projection (MYP) represents a minimum-reliable revenue and highest-planned expenditure scenario, which is not the most likely scenario but is mandatory for governance and useful for cautious planning. A deficit in this projection is a warning sign to be taken seriously, but it is a forecast only if one believes that District officials will not carry through on planned and required corrective actions.

For L.A. Unified, the best budget forecast is that the District will find ways to remain solvent, however painfully, both by using reserves as a buffer and by reducing costs. These actions are discussed in the remainder of this section of the report. However, this forecast is not guaranteed, because the necessary corrective actions are not guaranteed. The short-term question is whether the District will be able to stretch its reserves long enough to allow gradual, planned cost-cutting, or whether excessive spending now will necessitate more dramatic, unplanned cuts later. As discussed below, this paper recommends planning strategically and focusing on controlling major fixed costs to prevent more severe fiscal problems in the future and potentially losing local Board control of the District.

The Role of Inter-year Buffer Accounts

There are often intentional delays or unintentional timing mismatches between receipt of funds as revenues and use of those funds as expenditures. Funds may be received in a given year and pre-assigned for specific purposes in a following year. Conversely, expenditures during a given year may include purposes for which funds were assigned from a previous fiscal year. All unspent funds go into the year-end balances, which become beginning balances in the following year. When there are sufficient funds in these balances, they function as a buffer against running out of money in the new year.
The major elements of the General Fund ending balances for FY 2017 are listed in Table 1, showing both the budgeted amounts and the year-end actuals. This year-end balance for FY 2017 became the beginning balance for FY 2018. Note that not all of these fund labels are transferred from the ending balance statements to the subsequent beginning balance statements, even though the monies are transferred. They are simply not listed in the same way in the new year’s statements. However, the obligations and intentions they represent remain real, and are accounted for internally by the District even if unreported as such on the beginning balance statement.

Table 1: Detail of General Fund Ending Balances: Budgeted FY 2017 vs. Year-end Actual FY 2017 ($ millions)

<table>
<thead>
<tr>
<th></th>
<th>Budgeted FY 2017</th>
<th>Year-end Actual FY 2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stores</td>
<td>18</td>
<td>19</td>
</tr>
<tr>
<td>Prepaid Expenditures</td>
<td>-</td>
<td>2</td>
</tr>
<tr>
<td>Restricted Funds</td>
<td>151</td>
<td>163</td>
</tr>
<tr>
<td>Other Assignments</td>
<td>703</td>
<td>784</td>
</tr>
<tr>
<td>Unassigned Reserve</td>
<td>83</td>
<td>721</td>
</tr>
<tr>
<td>Reserve for Economic Uncertainty</td>
<td>73</td>
<td>73</td>
</tr>
<tr>
<td>Reserve for Revolving Cash</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td><strong>Ending Balance</strong></td>
<td><strong>1,031</strong></td>
<td><strong>1,765</strong></td>
</tr>
</tbody>
</table>


Note: Year-end actual balances for FY 2018 were not available as of the writing of this report, but indications from Budget Services show much smaller ending balances, i.e., reserves and assigned amounts, for FY 2018 than shown above for FY 2017. The Multiyear Projection created with the FY 2019 budget shows the reserves portion of the ending balances declining to under $4 million by the end of FY 2021.

In this table, Stores refers to inventories of physical goods like supplies and is small. Prepaid Expenditures is very small because District policy is to pay vendors after receipt of services, though there are exceptions like insurance. Restricted Funds are the leftover balances for specific programs that cannot legally be spent on other programs, such as Title I. Some of these are used to support activities from July 1 to September 30, when the Federal fiscal year ends. The Restricted Funds category is one that must be reported as such on both ending and beginning balance statements.

Other Assignments refers to resources that are intended for specific purposes in the coming year but do not meet the criteria for Restricted Funds. For example, non-recurring discretionary funding (‘one-time money’) received from the state at the end one fiscal year and planned for a specific purpose may be designated as assigned and included in the beginning balance for the following fiscal year. Rather than simply increasing the unassigned balance, this funding has been designated for specific purposes by the Board of Education, and will not be available for general spending. To the extent allowed, carryover amounts in the budget accounts of schools and divisions are also included as assigned because they have already been allocated for those budget items. If carryover amounts are recaptured for other uses instead of remaining available to those schools or divisions, they would come from the assigned funds.

Three of the lines in the table are classified as reserves, two of which are required. The Reserve for Revolving Cash is a small but practical necessity. The Reserve for Economic Uncertainty consists of funds held in reserve for unanticipated contingencies. This reserve is required to equal at least 1% of operating expenditures. District policy sets a target of 5% for the combination of this reserve and unassigned funds.

The remainder of the General Fund ending balance constitutes the Unassigned Reserve. This is the portion not classified as restricted, committed, or assigned. If, in any year, expenditures exceed revenues plus the restricted and assigned funds in the ending balance, the net shortfall comes out of the Unassigned Reserve.
while it lasts, thus diminishing the District’s reserves. District policy does not permit expenditures in excess of available funds, which consist of revenues plus beginning balances, not including the mandated reserves.

Flows of money in and out of these ending balances, including assigned funds and reserve funds, may soften the impact of deficits in any one year, but they cannot do so every year without becoming depleted. If present trends continue, the District’s reserve is projected to drop below its minimum level in three to four years, depending on assumptions about state funding and on actions taken by the District in the meantime. Figure 5 illustrates the District’s Multiyear Projection (i.e., not a most-likely scenario forecast) of the ending balance reserves through FY 2021. This shows budgeted amounts; the actual balances will not be known until after the end of each fiscal year.

Note that this figure shows two projections, i.e., two scenarios: one without a Fiscal Stabilization Plan and one with such a plan carried out. The Fiscal Stabilization Plan is defined and discussed in the next subsection.

**Figure 5. L.A. Unified Ending Balance Reserve Multiyear Projections**


Spending reserve funds is unsustainable unless there are years in which those funds are replenished.

**The Role of the Fiscal Stabilization Plan and Spending Cuts**

More important than reserves in the budget balancing process over time is the reduction of expenditures. In a year when the original budget shows a deficit, any cuts that become necessary during the year to balance the books by year end represent actions that were not specified in that budget. The major tool used to plan such cuts is the Fiscal Stabilization Plan (FSP).

The District must submit its annual budget, interim financial reports, and year-end actuals to the Los Angeles County Office of Education. In these submissions, the Board of Education must certify that the District will meet its financial obligations for the current fiscal year and two subsequent fiscal years. If the District might not be able to meet those obligations, its certification is called qualified rather than positive. In that case, the District must submit an FSP that details how it will be able to meet its obligations by the end of the third year.
The FSP is generally treated as an addendum to the budget although it must be adopted by the Board at the same time. Only the first year of the FSP represents an immediate intention and requirement to act by taking the cuts it specifies. The other two years of the FSP remain conditional on subsequent changes in revenue and/or spending plans. The FSP communicates concretely to stakeholders and governing agencies that the District will be able to meet its commitments, but it is subject to change, and its cuts may later become unnecessary.

The FSP is based on the MYPs as described above, and is subject to reasonably conservative constraints. Revenue funds that are anticipated but have an unclear probability of being realized may not be counted on. Any expenditures can be marked for reduction except anything that would require re-negotiating collective bargaining agreements or other long-term contracts. It is common for school districts to balance the FSP by cutting central office and school-site administrative costs, shifting expenditures from the General Fund to other funds where permissible, canceling ongoing service contracts, re-financing fixed costs, reducing the pre-funding of liabilities, selling assets, sweeping school-site year-end carryover amounts back into the General Fund, and—often last of all—increasing class size. The FSPs submitted by the District with its budgets for fiscal years 2017 through 2019 are shown in Tables 2-4.

**Table 2. Fiscal Stabilization Plan, FY 2017 Budget Adopted June 2016 (§ millions)**

<table>
<thead>
<tr>
<th>Cost Containment Strategies</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central Office Reduction (30%)</td>
<td>-</td>
<td>60.0</td>
<td>60.0</td>
</tr>
<tr>
<td>Zero Out School Allocation Carryover</td>
<td>-</td>
<td>269.0</td>
<td></td>
</tr>
<tr>
<td>Class Size Increase of 9 Average for Grades 4-12, Equivalent to ~2,000 FTE</td>
<td></td>
<td>153.7</td>
<td>153.7</td>
</tr>
<tr>
<td>Administrator Norm Increase ~300 FTE</td>
<td></td>
<td>36.0</td>
<td>36.0</td>
</tr>
<tr>
<td>Ongoing and Major Maintenance</td>
<td></td>
<td>15.0</td>
<td>15.0</td>
</tr>
<tr>
<td>Bond-eligible Maintenance Project</td>
<td></td>
<td>30.0</td>
<td>30.0</td>
</tr>
<tr>
<td>Elimination of Pre-funding OPEB Liability</td>
<td></td>
<td>101.3</td>
<td></td>
</tr>
<tr>
<td>Annual Savings</td>
<td>-</td>
<td>655.0</td>
<td>294.7</td>
</tr>
<tr>
<td>Cumulative Savings</td>
<td>-</td>
<td>655.0</td>
<td>959.7</td>
</tr>
</tbody>
</table>


**Table 3. Fiscal Stabilization Plan, FY 2018 Budget Adopted June 2017 (§ millions)**

<table>
<thead>
<tr>
<th>Cost Containment Strategies</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Redirection of School Site Carryover</td>
<td>-</td>
<td>(98.5)</td>
<td>246.0</td>
</tr>
<tr>
<td>Class Size Increase of 4 Average for Grades 4-12, Equivalent to ~1,000 FTE</td>
<td></td>
<td></td>
<td>76.0</td>
</tr>
<tr>
<td>Elimination of Pre-funding OPEB Liability</td>
<td>-</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Annual Savings</td>
<td>-</td>
<td>1.5</td>
<td>422.0</td>
</tr>
<tr>
<td>Cumulative Savings</td>
<td>-</td>
<td>1.5</td>
<td>423.5</td>
</tr>
</tbody>
</table>

Table 4. Fiscal Stabilization Plan, FY 2019 Budget Adopted June 2018 ($ millions)

<table>
<thead>
<tr>
<th>Cost Containment Strategies</th>
<th>Fiscal Years</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2019</td>
</tr>
<tr>
<td>Central Office Reduction</td>
<td>-</td>
</tr>
<tr>
<td>Address Administrator to Teacher Ratio (R2)</td>
<td>35.0</td>
</tr>
<tr>
<td>Change in Procurement Cycle</td>
<td>5.0</td>
</tr>
<tr>
<td>Attendance Incentive Increase</td>
<td>-</td>
</tr>
<tr>
<td>Reed Discontinuation</td>
<td>-</td>
</tr>
<tr>
<td><strong>Annual Savings</strong></td>
<td>40.0</td>
</tr>
<tr>
<td><strong>Cumulative Savings</strong></td>
<td>40.0</td>
</tr>
</tbody>
</table>


Some observations may be made about Tables 2 through 4:

- The first year of the three-year FSP sometimes does not show any savings. This is because that year is the current year of the budget being adopted at the same time, and planned reductions might appear in the budget itself rather than in the FSP.

- There is virtually no correspondence between FSPs from different years regarding the cuts to be made, even when those cuts are scheduled for the same year. This is related to the fact that an FSP is based on the new annual budget it accompanies, not on the previous FSP. Many events take place during a year that change the revenues, expenditures, and ending balances that form the starting point for the following year's budget. Thus, each FSP is highly dependent on the events of the fiscal year preceding its adoption.

- The third year keeps moving. For example, the third year of the FY 2017 FSP is FY 2019, which is the second year of the FY 2018 FSP and the first year of the FY 2019 FSP. By the time it arrives, it is no longer a third year but a first year, and bears little resemblance to its first appearance two years previous.

- In the same vein, the cuts identified in the second or third year of an FSP are often not executed, and might never be needed, because the fiscal circumstances will have changed by then, and different planning priorities might have been established.

- However, once a Fiscal Stabilization Plan is formally adopted and reported to County and State agencies, the District is obligated to implement it with fidelity unless conditions change to the better or greater cost savings through other measures are identified and implemented, over the three-year period covered by the plan.

- The FSP is sometimes but not always backloaded, meaning that the largest cuts are deferred until the third year. This is a rational strategy when the constraints on the FSP seem too conservative, such as when indefinite additional revenues are anticipated. It also buys time to discover other solutions to a deficit that might not have been apparent or eligible when the FSP was created.

- Depending on the District's degree of confidence in revenue increases, it might be wise to take larger cuts in the first and second years of an FSP instead of relying on a fictitious third year to provide the appearance of a solution. In any case, the first year is not too early to do serious planning for the third year, perhaps motivated by the desire to avoid the more serious cuts identified in the FSP for the third year.

When combined with a budget that shows a deficit, the Fiscal Stabilization Plan shows how the deficit can realistically be reduced over a three-year period without additional revenue, though it does not mean the FSP will be carried out in its entirety. The impact of the FSP on the projected deficit in the FY 2019 budget can be seen in Table 5.


### Table 5. Revenue and Expenditure Multi-year Projections, FY 2019 Budget ($ millions)

<table>
<thead>
<tr>
<th></th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
</tr>
</thead>
<tbody>
<tr>
<td>Projected Revenue</td>
<td>7,510.1</td>
<td>7,284.7</td>
<td>7,237.8</td>
</tr>
<tr>
<td>Projected Expenditures w/o FSP</td>
<td>7,525.4</td>
<td>7,486.8</td>
<td>7,488.3</td>
</tr>
<tr>
<td>Projected Surplus (Deficit) w/o FSP</td>
<td>(15.3)</td>
<td>(202.0)</td>
<td>(250.5)</td>
</tr>
<tr>
<td>Cumulative Surplus (Deficit) w/o FSP</td>
<td>(15.3)</td>
<td>(217.3)</td>
<td>(467.8)</td>
</tr>
<tr>
<td>Budgeted Expenditures with FSP</td>
<td>7,485.4</td>
<td>7,374.1</td>
<td>7,380.6</td>
</tr>
<tr>
<td>Projected Surplus (Deficit) with FSP</td>
<td>24.7</td>
<td>(89.3)</td>
<td>(142.8)</td>
</tr>
<tr>
<td>Cumulative Surplus (Deficit) with FSP</td>
<td>24.7</td>
<td>(64.6)</td>
<td>(207.4)</td>
</tr>
</tbody>
</table>


Notice that the three-year cumulative projected deficit without the FSP is $467.8 million, but the same projected deficit with the cost-cutting actions spelled out in the FSP is $207.4 million, or less than half of what it would be without the FSP. Which is the most likely scenario? If you take the FSP at face value, you might forecast a cumulative deficit of $207 million. If you assume that the District is unable or unwilling to follow through with its own FSP, you might forecast the larger cumulative deficit of $468 million. If you reasonably expect additional funds even though they might not fit the criteria for the FSP, and/or if you reasonably expect the District to carry out spending cuts that are not included in this FSP, you might forecast a cumulative deficit even lower than the $207 million shown here.

It is important to note that the cuts listed in the FSP are not included in the published budget as such, although the FSP is published with the budget and must be adopted by the Board at the same time. This can lead to confusion when talking about anticipated deficits. For example, where the budget may show an expected deficit of $400 million at the end of three years, the budget as modified by the FSP will show the elimination of that deficit. By the time someone can say, “If the District continues on the track it’s on, it will have a $400 million deficit in three years,” the FSP will have been adopted and the earlier of its cuts will be already in preparation or in process. The statement is no longer an accurate reflection of the fiscal reality. However, the cuts in the FSP should be taken seriously. A better statement might be, “The District is avoiding a predicted $400 million deficit by making the following cuts beyond any identified in the budget itself.”

### Dependence on Delayed Spending Cuts

The three-year FSP adopted with the annual budget can be a clumsy instrument for fine-tuning a multi-year budget. It results in a need to make previously un-budgeted cuts in spending, whether such cuts are included in the FSP or chosen as short-notice alternatives to FSP cuts. Many of these are enacted midyear as required to manage the year-end balance, based on updated information from the first and second interim financial reports.

During FY 2017, this management was accomplished in several ways—some strategic and some opportunistic. Lower water and power usage saved $7 million, which resulted from good weather combined with some conservation efforts. A hiring freeze for central staff was instituted, a strategic move that saved approximately $37 million. Meanwhile, preparations were begun for a substantial reduction in force among central office staff in the following fiscal year. At the same time, $6 million that was planned to be spent on student attendance incentives was not spent. Except for the conservation savings, these apparent savings actually represent spending plans already adopted that the District was not able to carry out.

Because of the timing, many possible cuts cannot be made in the current fiscal year, but initial steps must be taken to prepare for the cuts effective the beginning of the following year. Typically, these are cuts already specified in the FSP. Also because of the timing, the types of cuts that can be made are limited.
Staffing reductions require substantial lead time for notices, and certificated staff are better protected than are classified staff. Programs with high personnel costs are more difficult to cut midyear than those with higher material costs. Thus, even though a program with high personnel costs might be strategically appropriate to cut, and might offer greater savings, it cannot be cut if the action is delayed until late in the fiscal year.

When the District finds itself in midyear facing a deficit in either the current year or the following year, its “hands are tied”, as budget managers sometimes say. It cannot generate more revenue on short notice. It can only take limited cuts in the current year, especially since the cuts specified for that year in the FSP may have already been taken. It must begin preparing to take the cuts specified by the FSP for the following year. Note that these cuts are consistent with closing the year with balanced books, even though they represent departures from the original budget. Aside from the use of non-revenue available funds, they are the primary mechanism by which an actual year-end deficit is avoided.

**A Fiscal Problem and/or a Planning Problem?**

The District has budgeted deficits in most of the last several years, but it has shown balanced books in the year-end actual financial statements. Does this constitute a structural deficit? The semantics of this question can lead people to different answers. In one view, this is not a structural deficit as long as it can continue to be resolved by the end of each year as has usually been the case. To put it another way, it might not be a structural deficit as long as there are remedies such as those described above that allow short term course corrections.

However, some of those remedies appear not to be sustainable over the next several years, especially since they involve consumption of reserve funds. The combination of deliberate and opportunistic cost management has worked up until now, and it could hypothetically work indefinitely. But when the District projects what it needs to spend over time to meet its goals and finds that this exceeds the funds it is likely to receive, a problem exists. This is a structural deficit. This kind of deficit cannot be discerned from examining any one fiscal year’s budget or ending balances; it becomes apparent when considering a longer period of time and taking into account the possible exhaustion of available reserves and other solutions.

In short, the District does not face fiscal catastrophe unless it either (a) fails to implement the FSP and does not take the available steps in time to avoid a crisis, or (b) is locked into long term obligations that cannot be met with actual revenues and cannot be modified before falling under the constraints and time frames set by the one-to-three-year cycle of budgeting with an FSP. It is always possible to cut your way to fiscal balance, if you start early enough and cut smartly. The question is how long to wait and where to cut.

<table>
<thead>
<tr>
<th>The District does not face fiscal catastrophe unless it either</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) fails to implement a Fiscal Stabilization Plan and does not take the available steps in time to avoid a crisis, or</td>
</tr>
<tr>
<td>(b) is locked into fixed obligations that cannot be met with actual revenues, might not be eligible for cutting within the allowable terms of an FSP, and are not modified by negotiation or other intervention early enough to avoid a crisis.</td>
</tr>
</tbody>
</table>

The true challenge of a structural deficit is not found within the short-term budgeting cycle and annual documents. It requires an understanding of long-term revenue and expenditure trends. Section Three of this
report discusses those trends and their implications. However, the above analysis of short-term budgeting reveals three serious concerns that might not be apparent in many discussions of a structural deficit. The first is what might be called the habit of optimistic budgeting. A second concern is continuing to maintain the status quo through line-item budgeting which makes the budget opaque to decision-makers and the public. A third concern is the need to take a longer-term strategic approach to planning and budgeting. All three of these concerns are discussed below.

The Tendency for Optimistic Budgeting

A budget deficit means that planned expenditures exceed expected revenues. The distinction is important. The District does not control its future by adjusting revenues, which are largely beyond its control. (The revenues that can be controlled directly are relatively small compared to the size of total revenues.) The District controls its future primarily by changing expenditures, which are planned.

Why, then, does the District often plan for higher expenditures than the revenues it is likely to receive? Doing so may be rational to an extent. It accounts for the availability of beginning balances, although that rationale becomes less plausible when balances are projected to be exhausted within a few years. At times, it may also account for funding that is expected in midyear but not yet sufficiently guaranteed to write into the budget. It provides flexibility so that schools and program managers can adapt to circumstances by spending money already authorized to them instead of having to request them, although this rationale may create incentives to use or lock in one's budget allocation early in the year. It reflects the urgency of providing education to the students we have now, postponing hard decisions as long as possible. This is sometimes reflected in the habit of backloading the FSP, i.e., placing most of the cuts in the third year of the plan.

Unfortunately, when hard decisions are postponed, they can result in lower effectiveness and efficiency, because the range of options becomes narrower over time. This is especially difficult because of the labor-intensive nature of education, the District's high dependence on its personnel, and the resulting dominance of payroll and benefits in its budget. Such a reliance on human resources, characteristic of all school systems, means that the fiscal decisions with the largest potential impact on deficits are those involving compensation and staffing levels. Such decisions require substantially more lead time than most other fiscal decisions, and those that involve collective bargaining are ineligible for inclusion in the 3-year FSP.

There is a natural incentive for decision-makers to place unpopular cuts in the FSP instead of in the budget. This creates distance between the decision-maker and the cut, making the cut appear—when it occurs—as an after-the-fact necessity and not a proactive management choice. Thus, for example, the decision to increase class sizes in the last year of an FSP is a paper exercise and not a consequential management action. The decision can be made within the safety of claiming that ‘the third year never comes’, while the execution of the decision can later be made within the safety of claiming that ‘our hands are tied’.

There is also a natural incentive for those who have contracts with the District to push for higher spending locked into their contracts, and to argue for postponing cuts until it is too late to take spending away from them. This tendency is reinforced by the values of the District, which include a very strong desire to serve today's students with every means available, a deep optimism that every child can learn, and a genuine concern for the well-being of the people who teach and serve those children.

All these incentives can result in budgeting optimistically, frontloading commitments and backloading cuts. There are two additional points to note here.

First, we are not attributing the tendency for optimistic budgeting to budget staff, whose job is not to set the priorities but to implement the decisions and priorities of District top leadership, and whose profession points in the opposite direction of conservative budgeting. Nor are we attributing optimistic budgeting to labor partners or other contractors, whose natural incentives are to protect their own interests within the limits set by the system that exists. Rather, we are describing the District as a system—and the processes...
and incentives that create pressure on the shape of the final budget—as tending toward a style of optimistic budgeting that can interfere with strategic fiscal management.

Second, the tendency toward optimism is not bad in itself, especially in education. But it is dangerous for an organization if it takes the place of thoughtful and balanced planning. If year-to-year budgeting is done optimistically, and cutting is done opportunistically, as late as possible, the result is unlikely to be optimal for the mission of the organization.

The Unintended Consequences of Line-Item Budgeting

A second concern is the role of line-item budgeting in (a) carrying the momentum of the status quo from one year to the next, and (b) rendering the strategic implications of the budget opaque to decision-makers and the public.

Line-item budgeting is one of many ways to approach a public agency budget, several of which are described in Appendix B. Some of these approaches may be combined to an extent. They differ in how much control they provide, how much they cost to administer, and what they emphasize as the main focus of decision-making. Line-item budgeting is mandatory for the District’s primary budget documents and has many advantages, but it also comes with some disadvantages that should be recognized and compensated for.

One way to understand the differences among budgeting approaches is to consider how they categorize spending. Each dollar spent or budgeted may be accounted for in multiple simultaneous ways, i.e., categorized along different dimensions. The most important dimensions for understanding school district budgeting are illustrated in Figure 6. A single dollar may be viewed according to what fund it comes from, e.g., Unrestricted General Fund, what object it is to be spent on, e.g., Certificated Salaries, what function it performs, e.g., Instruction, where it is spent in terms of location, division, or department, e.g., a specific school, and what program or service it is spent on, e.g., the International Baccalaureate program. (An exception is specially funded programs, where the fund and the program are identical.)
This shows that a single dollar may be interpreted along at least five dimensions, probably more. However, it is difficult to focus on more than about three of these, especially when using two-dimensional tables as a primary analytical and communication tool. Public agencies must use fund accounting because their financing comes from government sources with various accountability requirements. The object dimension is vital for controlling resources at the point of expenditure. These two dimensions form the main axes of line-item budgeting. Given the ability to manage a third dimension, it is typical to identify function as that third dimension. However, this relegates location and program to a lesser role, at the cost of additional tables or increasingly difficult computer queries.

Thus, line-item budgeting tends to focus attention on (A) and (B) in the figure, and to a lesser extent (C). Location and program budgeting can be clearly identified as focusing on (D) and (E), respectively. Capital budgeting is very different, and is used by certain divisions such as Facilities and Information Technology because of the long-term asset nature of their focus. A variation of line-item budgeting is incremental budgeting, where changes from one year to the next are not planned independently, but applied as percentages across multiple categories. Finally, an approach called zero-based budgeting requires starting each line item and program at zero every year, rather than using the previous year as a starting point, and reviewing each line item and program to justify its inclusion in the next year’s budget.

Definitions
Fund: where the dollar came from
Object: what was purchased with the dollar
Function: what role that purchase supported within the District’s organization
Division, Department, or Location: what administrative unit the purchase served
Program or Service: what unifying theme, purpose, or activity connects this dollar with others spent the same way

Figure 6. Five Simultaneous Ways to Account for the Same Dollar

(A) Fund
(e.g., Unrestricted General Fund)

(B) Object
(e.g., Certificated Salaries)

(C) Function
(e.g., Instruction)

(D) Division, Department, or Location
(e.g., Marshall High School)

(E) Program or Service
(e.g., International Baccalaureate)
The District uses the line-item approach combined with elements of incremental, site-based, and program budgeting. The General Fund primarily follows the line-item approach because it complies with county and state accountability requirements, it is relatively less expensive to administer than some other approaches, and it has the weight of long-standing tradition behind it. It also provides stronger centralized controls against fraud and abuse, although it may be weaker than some other approaches in supporting/encouraging/generating innovation and protecting against systemic waste. However, it has unintended consequences that make it harder for L.A. Unified to manage its budget strategically, two of which we identify as momentum and opacity.

**Momentum**

The line-item budget process starts a new year’s budget for each line item with that line item’s previous budget, and then modifies it as necessary to accommodate changing priorities and changes in funding. While this is efficient to administer, it defaults to the status quo wherever no changes are specified in constructing the new budget. With a looming budget deficit, the budgeting exercise becomes one of cutting away things that people have and want to continue having, rather than proactively planning the best use of available resources.

In part, this momentum of the budget from one year to the next occurs because a majority of the District’s costs are for employee salaries and benefits. Given the District’s policies and collective bargaining agreements, employee positions are semi-permanent. A budget-cutting exercise becomes one of identifying positions to cut, and these decisions must be made early enough to provide the requisite notices.

The momentum built into the District’s employment structure is one reason for the oft-repeated dictum that so-called one-time money should not be used for ongoing programs. What this really means is that one-time money should not be used to create new positions, an act that locks the District into a commitment to keep and compensate those positions year after year unless the more difficult decision is made to eliminate them.  

This kind of momentum has some advantages. In particular, it contributes to stability in an organization and provides staff engaged in ongoing programs or multi-year projects that the resources necessary to continue their work into the next year will probably be available. The extreme alternative, zero-based budgeting, can replace that confidence with inhibiting concern about whether a specific activity will be continued beyond the current year. Rather than eliminating budgetary momentum, it may be more important to recognize its existence and value, and reduce its negative consequences by ensuring that the budget process is structured to allow thoughtful planning and substantially reduce but not eliminate the momentum of the status quo.

**Opacity**

A common complaint about the District’s budgeting process and reports is that they lack transparency, or in other words, they are opaque. One reason for this can be seen in Figure 6, above. In the published line-item budgets of the District, it is easy to find A (fund) and B (object), and with only a little more effort C (function). Also with a little effort, it is possible to find E for school sites. It is much more difficult to find E for divisions or departments, and even more difficult to find F (programs) except in cases where the program is specially funded and therefore identified by the fund.

This affects not only the public and other stakeholders, but also District decision-makers. Decisions to add programs or add resources to a location may be made without a transparent understanding of the costs involved. While a decision-maker may indeed have an exact number for the line-item dollar costs of a decision, it is more difficult to gain a global picture of the true cost relative to other priorities. This can

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5 See Independent Analysis Unit, *Possible Uses of Discretionary Non-Recurring Funds*, for a discussion of such one-time funds.
exacerbate the planning problems underlying budget deficits. Again, what is needed is not necessarily to eliminate line-item budgeting, but to mitigate its negative unintended consequences.

**The Need to Take a Long-Term Strategic Approach**

Since the District has relatively little control over revenue, managing its fiscal condition means managing its costs. As noted above, it is common to generate an unbalanced budget with optimistic expenditures, and then attach an FSP that itemizes cuts to be taken over a three-year period. In that way, the cuts are not part of the original budget. Furthermore, any intra-year cuts made to ensure balanced books at year-end are also not part of the original budget. And waiting until the District's "hands are tied" to make those cuts constrains them to what is permissible and possible at that time, resulting in a narrower range of choices than might have been available with earlier planning and preparation. Thus, we see a combination of factors: (a) the constraints built into the FSP, (b) the use of short-term or midyear cuts to balance the books, and (c) planning processes that do not clearly connect the dots between District strategy and budget line items. The result of these three factors is that the kinds of cuts that are made are the easy ones—the low-hanging fruit—and not strategic ones.

Forced and opportunistic austerity like this can stimulate improvements in efficiency up to a point. However, too much austerity can cripple an organization, and cutting costs this way rather than with thoughtful planning can harm rather than help efficiency. *Anything that could be cut midyear under the threat of a deficit could also be cut by intention as a result of planning before the year starts. The converse is not true—some cuts that could be achieved with enough lead time cannot be made in midyear.*

Note that the 2004 report from MGT of America recommended that the District "review functional, organizational, and business operations of the District so that future staff reductions of the elimination of positions are done in an informed manner." Since 2004, however, the District has gone through staff reductions that were applied as percentage cuts across the board rather than in the informed manner suggested here. A major reason is that across-the-board percentage cuts do not take as much staff time to plan as strategic cuts. This is a vicious circle, since planning and budgeting staff are usually cut before school or school support staff. Thus, one round of simple across-the-board cuts in administration reduces the planning and budgeting staff needed to ensure that the next round is anything better than simple across-the-board cuts.

In general, it is better to plan ahead for targeted cuts than to balance the books by making suboptimal cuts under deadline pressure. Unfortunately, the budget cycle, with its mandated reporting several times a year and the legal requirement to pass a budget by June of each year, does not provide much opportunity to do such planning.

The District engages in longer and shorter term planning in a variety of areas. There is a District Strategic Plan, and several divisions (prominently Facilities and Information Technology) publish their own Strategic Execution Plans. However, the annual budget does not appear to be well-integrated with long-term District strategic planning. These probably cannot be integrated without a structure and process to make them so.

The long-term approach to planning allows deeper solutions to fiscal problems, such as thoughtful changes in organizational structure. The long-term approach allows--requires--strategic analysis of specific expenditures in terms of their relationship to District goals, not simply naming those goals as a compliance checkoff, but articulating a model of how the expenditures are expected to bring about the goals. The long-

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term approach provides an opportunity to re-evaluate those goals with a realistic assessment of the true cost of achieving them.

**Recommendation: Create a Long-Term Strategic Financial Plan**

The IAU recommends that the District develop and regularly update a long-term strategic financial plan (LTSFP). This is in agreement with the Government Finance Officers Association (GFOA), which recommends that a school district create a strategic financial plan focused on mission rather than compliance, covering three to five years into the future.7

The existing District budgeting process follows a schedule and format prescribed by the state and the Los Angeles County Office of Education. It is essential to comply with these laws, regulations, and generally accepted principles. However, it is also important to recognize that a compliance-driven approach to budgeting leaves out important mission-driven considerations. Most importantly, it is necessary to get away from the reliance on the compliance-oriented FSP as a primary long-term financial planning document.

The IAU has examined a wide variety of sources about strategic planning and financial planning in search of a useful model to use in approaching the District's challenge. There are thousands of 'experts' in these fields, many promoting their own complex models with many moving parts. The GFAO best practices described in Appendix B are excellent models for the District to consider, except that they are not feasible to implement fully in this context.

There are some points of agreement among these models. Rather than select any one model, the IAU has extracted four key elements that are common to most models, and offers a simplified model with these four elements. The four elements are **mission**, **strategy**, **structure**, and **budget**. The relationships among these are illustrated in Figure 7 and the bullet points below it.

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Definitions

- Mission is the purpose of the organization and its intent to fulfill that purpose: what it does, why, and for whom.

- Strategy is the plan of coherent action that is intended to accomplish the mission in the context of real-world opportunities and threats.

- Structure is the design of the organization and its assets (social, informational, physical) to carry out the strategy.

- Budget is the recurring reconciliation between the intention to use resources by the organization and the availability of resources to the organization.

Relationships

- Strategy, Structure, and Budget should be determined by Mission.

- Mission is enabled by Strategy, Structure, and Budget.
  
  In other words, mission identifies ends; strategy, structure, and budget are the means to those ends.

- Structure should be determined by Strategy.

- Strategy is enabled by Structure; thus, Strategy is limited to what can be done with Structure.
  
  Note that structure is far more stable (harder to change) than strategy, so it’s natural—and common—to let structure determine strategy rather than vice versa. A better approach is to design the structure with the flexibility to accommodate new strategies that are likely to be needed within the lifetime of the structure.

- Budget should be determined by Strategy and Structure as prioritized by Mission.

- Strategy and Structure are enabled by Budget. Thus, Strategy and Structure are limited to what can be funded in Budget.

Although this model connects every element of the budget equally to mission, strategy, and structure, the conventional line-item approach to budgeting essentially makes budget an extension of structure, and can make it very hard to continually re-connect budget to mission and strategy.
In L.A. Unified, the connections that are drawn between the budget, strategy, and mission mainly consist of (a) the slow evolution of the status quo structure, which has been developed over time with mission and strategy in mind, but which responds only slowly when strategy changes; (b) pro forma statements attached to spending items claiming that there is a connection to certain strategic goals of the District by naming those goals; and (c) add-on programs that have clear missions but are not well-integrated into the whole budget. What is missing is a clearly articulated theory of action that shapes budget priorities by mission, strategy, and structure rather than mainly by structure.

The District’s structure is slow to change, because it is closely tied to building locations, labor contracts, and cultural norms that intrinsically resist moving away from traditional models of schooling. Sections Three and Four of this report address some of these issues on a deeper level. These challenges will not be solved by a short-term budget. However, the present is the essential place to start in order to buy time to bring about deeper change, and an essential tool for that purpose is a Long-term Strategic Financial Plan.

Elements of a Long-Term Strategic Financial Plan

The following description of the recommended Long-term Strategic Financial Plan (LTSFP) is derived in part from the recommendations of the GFOA cited above, in part from other literature on strategic and financial planning for public agencies, and in part from the IAU’s analysis of what the District needs. Some elements already exist in the District, but are not integrated into a single LTSFP. Note that these are not presented by the IAU as take-it-or-leave-it recommendations, but as starting points for a collaborative process involving multiple leaders, offices, and stakeholders of the District in developing a plan that will not only work in this District but also gain the necessary support and ownership.

- **The LTSFP is not a budget and need not meet county or state reporting criteria.** It is a complement to the mandated annual budgeting cycle, not a substitute.

- **The LTSFP represents a budget planning process that is longer-term than an annual budget with a 3-year FSP, at least five and preferably six years.** Different from the fiscal stabilization plan submitted to LACOE, this longer-term financial plan would reach beyond the required three years. This means it cannot consist of fixed or promised amounts that staff or other parties can take for granted. Projections and forecasts become more uncertain the farther they extend into the future, and commitments based on them need to be made carefully and not prematurely. Thus, the LTSFP needs to identify major budget components to consider changing, the operational decisions that drive those budget components, and what actions must be taken early to enable the actions intended for later. As management guru Peter Drucker stated, “Long range planning does not deal with future decisions, but with the future of present decisions.”

- **The LTSFP should follow, not precede, any updates to the Superintendent’s strategic plan. It should precede, not follow, development of a new annual budget.** Because the process of creating a new budget gains tremendous momentum from January to June, the strategic financial plan would ideally be presented for Board approval by November of every year so that there is time for it to have an impact on budget formation for the next year.

- **The LTSFP should provide usable guidance in developing the annual budget.** It should include a six-year budget sketch (broad categories, not excessively detailed) along with the assumptions made in developing the plan. It should discuss how the most recent annual budget aligns with this plan and how the next budget needs to change to fulfill the plan. In identifying prospective changes, it should not just

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list them as pluses and minuses in tables of figures, but provide a narrative of strategic changes, their rationale, and their impact.

- **This LTSFP and the process of developing it will be more mission-focused, strategy-organized, and action-connected than is possible in an annual line-item compliance-oriented budget.**

As recommended by the GFOA, there should be a *plan of action* covering roles and responsibilities for implementing the strategic financial plan.

The strategic financial plan should identify long-term priorities, preferably linked to the District's strategic plan, and will describe how the District intends to pursue these priorities.

The plan should state where priorities mean saying 'no' and not just 'yes'. It will identify options for deliberately reducing expenditures in those areas that are not prioritized, based on mission and strategy. This contrasts with opportunistic cuts based on what parts of the structure can be cut with least notice.

The planning process will include objective consideration of potential deep changes to District structure and operations that would be inconceivable as part of an annual budget or FSP cycle.

- **The LTSFP should be program and location oriented rather than line-item oriented.** Each organizational location, *e.g.*, each local district and division, should be responsible for creating its own plan within District guidelines, focusing on the program priorities that they expect to implement. It would be ideal for each school site to create its own plan as well, although this would require augmenting the administrative capacity of the schools and is probably not feasible right away.

- **The LTSFP should be used as a tool in developing and maintaining visible coherence between mission, strategy, structure, and budget.** In some ways this is like the LCAP, but more transparent and offering more opportunity to plan deep changes, and including local districts and divisions, not just schools and the central office.

- **The LTSFP should include a reflective/diagnostic section.** This element of the plan and the process for creating it should include the following points:
  
  - Start with a ten-year or longer projection of major trends
  - Use the Superintendent’s strategic plan as a reference point. In what areas have fiscal considerations impeded or supported fulfillment of the strategic plan and accomplishment of goals?
  - Look at strengths, weaknesses, opportunities, threats (SWOT analysis) to assess the District in its environment.
    - **Strengths:** Assets, including human capital. Competitive advantage in areas from instruction to janitorial services. Economies of scale.
    - **Weaknesses:** Liabilities. Competitive disadvantage in areas from instruction to janitorial services. Diseconomies of scale.
    - **Opportunities:** Refer to the strategic plan. What fiscal opportunities exist to enable fulfillment of goals?
    - **Threats:** Refer to the strategic plan. What fiscal threats to fulfillment of strategic plan exist?
  
- **The LTSFP should anticipate budget responses to alternative enrollment, funding, and cost scenarios.** This allows the 3-year FSP to be treated as one contingency plan among many, not as the primary multiyear plan. The LTSFP can be used to plan in advance the changes necessary to avoid triggering an FSP in future years.
• The LTSFP is not about future decisions and actions. It is about making the present decisions and initiating the present actions necessary to enable making better decisions and provide better alternatives in the future. It will outline future budget parameters, not an exact set of numbers to be adhered to but as a framework for further decision-making.

In management guru Peter Drucker's words, "Some of the most important questions in strategic planning can be phrased only in terms such as 'larger' or 'smaller', 'sooner' or 'later', and some equally important areas cannot be quantified at all. They can only be handled as restraints, or parameters, but not as factors in the equation itself."

"Long range planning does not deal with future decisions, but with the future of present decisions." — Peter F. Drucker

As described here, the long-term strategic financial planning process will take intentional effort from the top of the organization down. The linkage between structure and budget follows well-established rules and precedents, and gives the status quo of the District great momentum. But the links between mission, strategy, structure, and budget that enable positive change in the face of budget constraints must be created by leadership and constantly renewed.

Summary

This section has discussed the District's fiscal situation from the perspective of short-term budgeting. The current budget includes projections of deficits that will exhaust reserves unless corrective action is taken. The longer such actions are delayed, the more difficult it will be to carry them out successfully. Such a deficit in the annual budget may be seen as threatening or benign depending on the assumptions, incentives, and time horizons of different observers. Focusing excessively on this short-term deficit can be a curtain behind which more serious problems easily remain unnoticed.

The District’s primary instrument for longer-term fiscal planning has been a series of three-year Fiscal Stabilization Plans (FSPs). However, this process does not result in optimal planning of cuts. Once an FSP is adopted, the district must adhere to it unless conditions change materially during the course of the year. What is needed is to make a more strategic plan that precedes and supersedes the fiscal stabilization plan.

Is this ‘fiscal catastrophe’? Only if the District runs itself out of reserves, which would happen if (a) an FSP is not implemented or (b) the District allows the growth of fixed expenditures to crowd out other expenditures and make strategic solutions impossible. While (a) seems unlikely, it is possible; other districts have lost local control to governing bodies for failing to implement such plans. And the District faces a real risk of (b) that might be overlooked in the short-term budgeting cycle using the FSP as a primary planning tool.

The District already engages in or has attempted to engage in most of the elements of strategic financial planning. However, those efforts have not been integrated, and some have not been well executed or sustained over time. As a result, the District remains without a long term strategic financial plan and a long term strategic financial planning process.

The IAU recommends that the District engage in long-term strategic financial planning—and create a Long-term Strategic Financial Plan (LTSFP)—apart from the annual budget and Fiscal Stabilization Plan. The characteristics of such an LTSFP are contrasted with an annual budget and an FSP in Table 6.

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<table>
<thead>
<tr>
<th>Table 6. Characteristics of Budgets and Financial Plans</th>
<th>Annual Budget</th>
<th>Fiscal Stabilization Plan (FSP)</th>
<th>Recommended Long-Term Strategic Financial Plan (LTSFP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Time Horizon</td>
<td>1 year plus 2-year projection</td>
<td>3 years</td>
<td>5-6 years</td>
</tr>
<tr>
<td>Authority</td>
<td>Spending authorization for one fiscal year</td>
<td>Authorization for the first year; contingency planning for the second and third years</td>
<td>Formal guidance in developing the next budget and in preparing for following budgets</td>
</tr>
<tr>
<td>Submission to Board</td>
<td>May</td>
<td>May</td>
<td>October</td>
</tr>
<tr>
<td>Board Approval</td>
<td>June</td>
<td>June</td>
<td>November</td>
</tr>
<tr>
<td>Budgeting Approach</td>
<td>Line-item/ Incremental/ Location</td>
<td>Mixed/ Opportunistic</td>
<td>Program/Location</td>
</tr>
<tr>
<td>Retrospective/Reflective Analysis</td>
<td>Nominal</td>
<td>None</td>
<td>Thorough</td>
</tr>
<tr>
<td>SWOT Analysis</td>
<td>Nominal</td>
<td>None</td>
<td>Thorough</td>
</tr>
<tr>
<td>Mission Integration</td>
<td>Nominal</td>
<td>None</td>
<td>Thorough</td>
</tr>
<tr>
<td>Strategy/Structure Integration</td>
<td>Controlled by structure</td>
<td>Nominal/opportunistic</td>
<td>Controlled by strategy and structure, with opportunity to change strategy and structure</td>
</tr>
<tr>
<td>Balance of Focus Between Present and Future Decisions</td>
<td>Focus on present decisions</td>
<td>Backload future decisions as much as possible in hopes they become unnecessary</td>
<td>Make present decisions and undertake present actions that enable better options for future decisions</td>
</tr>
<tr>
<td>Decentralized Control and Accountability</td>
<td>Limited (although moving toward more)</td>
<td>None</td>
<td>Interactive process</td>
</tr>
<tr>
<td>Contingency Planning e.g. in case of enrollment decline</td>
<td>Limited intra-year flexibility</td>
<td>Single contingency</td>
<td>Multiple contingencies</td>
</tr>
<tr>
<td>Integration with Collective Bargaining and Other Long-Term Contracting Processes</td>
<td>Virtually none</td>
<td>Disallowed</td>
<td>Much recommended</td>
</tr>
<tr>
<td>Room for Dialogue About Priorities</td>
<td>Little</td>
<td>Little</td>
<td>Much recommended</td>
</tr>
</tbody>
</table>
SECTION THREE: THE LONG-TERM TREND PERSPECTIVE

While the budget and its associated fiscal stabilization plan are one- to three-year documents, and the long-term strategic financial plan we recommend covers five to six years, the fiscal challenge facing the district consists of trends with an even longer time horizon. This section discusses long-term trends and projections for revenue and expenditures using the ten-year period from 2019 through 2028. Some of the major trends are likely to continue beyond ten years in the absence of major changes from funding sources or changes in the District. However, predicting major changes in funding policies is beyond the scope of this analysis, and the recommendations we make are about changes in the District, not external changes beyond the District’s direct control. The ten-year time horizon used here provides a good balance between the length of the projection and the uncertainty that increases with its length.

Revenue Trends

The largest component of District operating revenue since the 2013-2014 fiscal year has been the state’s Local Control and Funding Formula (LCFF). This is expected to remain true indefinitely unless there are changes in state policy. For this report, we focus on LCFF revenue and assume that variations in other, smaller sources would have a relatively small impact on the underlying fiscal trends, even if they go through large variations as a percent of the source.

The LCFF funding received by the District has risen substantially since LCFF was introduced in 2013, as shown in Figure 8. The increase over the last five years has occurred because the state initially underfunded LCFF, and has been increasing allocations every year to reach 100% of the authorized amount. Now that the 100% level has been reached, total LCFF revenue is expected to remain relatively flat or slowly decline over time. The solid line in the figure shows actual rates for the last five years, and the dashed line shows the projections made by L.A. Unified in its most recent budgets. These projections show a downturn between FY 2019 and FY 2021.

*As projected in the FY 2019 budget.
Funding from LCFF is allocated according to the Average Daily Attendance of students in a district, with adjustments for differences between grade levels and categories of student need. The projected leveling off of LCFF funds for L.A. Unified in the above figure is based on projections of declining ADA, which in turn are based on projections of declining enrollment, as shown in Figure 9. The solid lines are actual numbers for the last five years, and the dashed lines show the District's projections as given in recent budgets.

*Figure 9. Graded Enrollment and Average Daily Attendance (ADA), FY 2014 – FY 2021*

Although enrollment and ADA are expected to decline, and LCFF has reached 100% of its authorized level, the per-student funding rate of LCFF is expected to continue rising, though more slowly, due to Cost of Living Adjustments (COLAs). These are provided for in LCFF, but their application in any given year is subject to decisions by the state government, so they are not guaranteed. It is important to note that the LCFF COLA is not directly based on the rate of inflation, and should be viewed as a political and budgetary decision at the state level, not as compensation for rising prices in the economy. If future inflation rates are about the same as the LCFF COLA rates, the impact will be neutral. If there is a lower COLA and/or higher inflation in any given year, there will be negative fiscal results for school districts. Conversely, if there is a higher COLA and/or lower inflation in any given year, there will be a positive fiscal impact on districts.

The average LCFF per-student rates are shown in Figure 10. The solid line shows actual amounts over the last five years, and the dashed line shows the District's projections as given in recent budgets. These are based on L.A. Unified experience, considering the grade level profile and targeted need profile of its students. This figure shows that LCFF funding per student ADA has risen substantially over the last several years and is projected to rise a little more slowly with COLAs over the next few years.
In short, the negative impact of declining enrollment and ADA has so far been mitigated by rising per-student LCFF grants. The short-term projections in these figures show that this effect is weakening over time, resulting in a leveling-off of revenue followed by the gradual decline shown in Figure 8. If enrollments continue to decline beyond 2021, and if LCFF per-student rates are only increased by COLAs and not by additional funding from the state, the total revenue will continue its gradual decline for years to come. The next subsection discusses the implications of long-term revenue projections.

**Long-term Revenue Projections**

What can be said about future revenue beyond the FY 2021 horizon shown in the figures above? The farther projections extend into the future, the less reliable they become. For good reasons, the District’s published budget does not include projections beyond the mandated third year. However, for purposes of analysis and what-if considerations, it is useful to make projections for a longer period, while acknowledging their limitations or ‘fuzziness’.

Figure 11 illustrates four ten-year revenue projections that differ from each other only on their assumptions about the LCFF COLA and declines in District ADA due to declining enrollment. The two solid lines assume a declining ADA of 2.56% per year, while the two broken lines assume a recovery of ADA decline such that it becomes zero, i.e., flat, by 2028. The two black lines assume an annual LCFF COLA of 2.19%, and the two gray lines assume there is no COLA. These two sets of assumptions result in four projections, chosen to illustrate a best-case scenario (dotted black line), worst case scenario (solid gray line), and two intermediate scenarios (black line and dashed gray line). These projections also assume no major changes in state funding policies, and no state budget shortfall (such as in a recession) that is passed on to the schools.

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*As projected in the FY 2019 budget.
By 2028, the difference between the highest and lowest of these projections reaches about $1.8 billion. Starting from the FY 2019 revenue projected by the District, the worst-case scenario out of the four shown above would reach a decline of about $1.5 billion, or about 20% of current revenue. The solid black line on the graph corresponds to an assumption of ongoing COLAs in spite of continuing enrollment decline. Interestingly, it ends up at nearly the same place as the dashed gray line that assumes a recovery of enrollment decline and no COLAs. This provides support for focusing on a projection near the middle of this range, which the IAU does in the rest of this report.

**Expenditure Trends**

While income is flattening for L.A. Unified, expenditures over the past eight fiscal years have grown, though not in a straight line. It might be tempting to draw out a projection line for expenditures as was done above for revenues, but this would be misleading. If expenditures continue to climb, and revenues flatten or decline, such a projection would show the expenditure line rising far above revenues over time, resulting in large cumulative deficits. This would not happen because it cannot happen within District, County, and State policies. Long before this hypothetical state of affairs was reached, these oversight bodies would have intervened to prevent ongoing deficits.

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10 Assumptions:
ADA Decline refers to a constant level of decrease in Average Daily Attendance, based on the 5-year average rate of annual ADA decline since 2015-2016 (2.56%).
ADA Recovery refers to an 8-year leveling of Average Daily Attendance decline from 2021 through 2028. Specifically, ADA decline is projected to be 2.56% in FY 2021 (the average District rate over the past 5 years), then reduced by .36% each year until FY 2028, when decline reaches 0%.
COLA refers to the annual adjustment of LCFF rates by the state, using either 0% or 2.19% as the assumed rate. A 2.19% COLA is slightly above the average COLA from the past 3 years.
Non-LCFF sources are held constant as a percent of total revenue.

11 A projection that doesn’t change much under different scenario assumptions is considered more robust than a projection that is highly sensitive to its assumptions.
However, there is one prospective event that could create a fiscal disaster. If there are rising fixed costs that the District has committed to pay regardless of enrollment or revenue, and there is declining revenue or insufficient revenue to cover those fixed costs, the result will be a genuine crisis. It is important to identify the risk of such an outcome earlier rather than later, and to identify what preventive steps can be taken earlier rather than later.

Expenditures cannot exceed revenues indefinitely.

What happens when revenues decline over time is not so much a deficit as a necessary corresponding decline in total expenditures.

Some expenditures can more easily be reduced with lower revenue than others.

The fiscal danger lies with fixed costs that cannot easily be reduced when revenue declines, especially growing fixed costs that occupy a large fraction of the budget.

In the face of such a possibility, it is useful to identify (a) which expenditures have the greatest impact on current and projected spending growth, and (b) which expenditures reflect fixed costs that are not easily changed with revenue versus variable costs that can be adjusted with changing circumstances. Costs that meet both of these conditions cause the most concern.

Nearly all of the major spending line items in the budget have caused growth in expenditures, albeit in different ways. To determine which spending categories have had the greatest impact on expenditure growth, we focused on major categories using five criteria:

1. The current size of the category
2. The total growth of the category over the last seven years
3. Change in the category’s percent of total expenditures over the last seven years
4. The ratio of change in the category to change in overall expenditures (This is calculated as a ratio of percents, which we call the change ratio, and it shows how each category growth rate compares to the overall growth rate.\(^\text{12}\))
5. The annualized growth rate of the category

As shown in Table 5, different costs meet different criteria. Certificated Salaries is by far the largest category, nearly $3 billion in the budget. Books and Supplies along with Services and Operating Expenses are growing rapidly, but occupy a small percentage of the total budget. Only one category meets all five criteria to a strong degree: Employee Benefits is the second largest category by dollar amount at $2 billion, has had the largest total growth of $0.68 billion, shows the highest growth rate, and results in the largest change ratio with the strongest relationship to expenditure growth.

\(^{12}\) A ratio of percent change in one variable to percent change in another variable is known as an elasticity in economics. However, elasticity implies a relationship that works in both directions. The relationships shown here are ratcheted, meaning they work in one direction but are blocked from working the same way in the opposite direction. For example, benefits go up when salaries go up, but cannot drop at the same rate when salaries go down because some of the benefits go to retirees no longer receiving a salary. Thus, we use this ratio not as an elasticity, but as an indicator of how much one category has changed relative to another or to the whole, without implying that the relationship will work in reverse.
Table 7. Growth in General Fund Expenditures by Major Category, FY 2011 – FY 2018

<table>
<thead>
<tr>
<th>Category</th>
<th>FY 2011 $ in billions</th>
<th>% of Total (a)/Total(a)</th>
<th>FY 2018 $ in billions</th>
<th>% of Total (c)/Total(c)</th>
<th>Change in % of Total (d) – (b)</th>
<th>Growth $ in billions (c) – (a)</th>
<th>Growth as % of 2011 (f)/($)</th>
<th>Change Ratio (g)/Total(g)</th>
<th>Annualized Growth Rate (i)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Certificated Salaries</td>
<td>2.81</td>
<td>45.5%</td>
<td>2.84</td>
<td>39.6%</td>
<td>-5.94 pts</td>
<td>0.03</td>
<td>0.9%</td>
<td>0.056</td>
<td>0.15%</td>
</tr>
<tr>
<td>Classified Salaries</td>
<td>0.85</td>
<td>13.8%</td>
<td>0.98</td>
<td>13.7%</td>
<td>-0.15 pts</td>
<td>0.13</td>
<td>14.8%</td>
<td>0.921</td>
<td>2.05%</td>
</tr>
<tr>
<td>Employee Benefits</td>
<td>1.34</td>
<td>21.7%</td>
<td>2.01</td>
<td>28.1%</td>
<td>6.43 pts</td>
<td>0.68</td>
<td>50.5%</td>
<td>3.151</td>
<td>5.96%</td>
</tr>
<tr>
<td>Books and Supplies</td>
<td>0.35</td>
<td>5.7%</td>
<td>0.42</td>
<td>5.9%</td>
<td>0.14 pts</td>
<td>0.07</td>
<td>18.8%</td>
<td>1.172</td>
<td>2.64%</td>
</tr>
<tr>
<td>Services/Operating Exp</td>
<td>0.68</td>
<td>11.0%</td>
<td>0.85</td>
<td>11.9%</td>
<td>0.83 pts</td>
<td>0.17</td>
<td>24.7%</td>
<td>1.543</td>
<td>3.24%</td>
</tr>
<tr>
<td>Other Exp</td>
<td>0.14</td>
<td>2.3%</td>
<td>0.07</td>
<td>1.0%</td>
<td>-1.31 pts</td>
<td>(0.07)</td>
<td>-51.0%</td>
<td>-3.181</td>
<td>-9.43%</td>
</tr>
<tr>
<td>Total Expenditures</td>
<td>6.20</td>
<td>100.0%</td>
<td>7.17</td>
<td>100.0%</td>
<td>0.00 pts</td>
<td>0.99</td>
<td>16.0%</td>
<td>1.000</td>
<td>2.10%</td>
</tr>
</tbody>
</table>

Source: L.A. Unified Superintendent’s Final Budget FY 2011 and FY 2018
The five criteria are summarized as follows:

1. *The current size of the category (columns c and d):* The largest category is Certificated Salaries, with $2.84 billion or about 40% of total expenditures in FY 2018. Employee Benefits (which includes retiree benefits) is second in size, with $2.01 billion or about 28%.

2. *The total growth of the category (column f):* Employee Benefits made by far the largest contribution to expenditure growth, at $680 million or 69% of all growth. The next largest contribution was only $170 million or 17% of all growth, for Services and Operating Expenses.

3. *Change in the category’s percent of total expenditures (column e):* Employee Benefits increased as a percent of total expenditures from 21.7% to 28.1%, or an increase of 6.4 percentage points. No other category increased its share by as much as one percentage point, and Certificated Salaries decreased its share from 45.5% to 39.6%, or a decrease of 5.9 percentage points.

4. *The ratio of change in the category to change in overall expenditures (column h):* Employee Benefits changed at a ratio of over 3:1 compared to total expenditures. No other category changed at a ratio greater than 2:1.

5. *The annualized growth rate of the category (column i):* Employee Benefits grew at 5.96% per year, nearly double the rate of Services and Operating Expenses, the second fastest growing category at 3.24% per year. The growth rate of salaries, combining Certificated and Classified, was only 0.61% per year during this period.

Thus, although employee benefits do not consume as much of the budget—at present—as employee salaries, the cost of benefits is growing much faster. Figure 12 shows the growth of salaries and benefits costs using actual figures from FY 2011 through FY 2018, and a hypothetical (not necessarily realistic) constant annual rate of growth through FY 2028 of 0.61% for salaries and 5.96% for benefits.

*Figure 12. Hypothetical Growth in Employee Benefits: FY 2011–FY 2028*

![Graph showing hypothetical growth in employee benefits from FY 2011 to FY 2028.](image)

**Source:** L.A. Unified Unaudited Actuals FY 2011 - 2017, Final Budget FY 2018, IAU projection through FY 2028 using constant annualized growth rate of 0.61% for salaries and 5.96% for benefits.

If these growth rates continue, salaries will cost $4.06 billion and benefits will cost $3.59 billion in FY 2028. The result is a total compensation cost of $7.65 billion in FY 2028, i.e., more than the District’s total General Fund expenditures in FY 2018. This is clearly unrealistic unless revenue increases proportionately.
Note, however, that the actual cost of salaries dipped during the FY 2012 – FY 2015 period. The resulting 0.61% annual growth rate for salaries is almost certainly too low an estimate without substantial reductions in force, assuming individual wage rates must rise faster than that. The estimated 5.96% growth rate in benefits may also be too low, because of expected increases in pension contribution rates and the rising cost of health care for retirees, which will continue to rise even if staffing levels and total salaries decline.\footnote{Independent Analysis Unit. Health and Welfare Costs and Benefits, 2017.}

The two questions raised at the beginning of this subsection were (a) which expenditures have the greatest impact on spending growth, and (b) which expenditures reflect fixed costs that are not easily changed with revenue. The above analysis provides an answer to (a) in that the rising cost of benefits is having and will probably continue to have the greatest impact on spending growth. To answer (b), it is useful to distinguish among different types of benefits, which is done in Figure 13. This figure improves on the constant growth rate projections in Figure 12 by introducing more specific assumptions and by separating types of benefits.

In Figure 13, the IAU has projected total benefits costs as a composite of Pension, Health and Welfare, and Other benefits costs, resulting in a slightly higher predicted total cost for FY 2028 than above. These projections include the cost of retiree benefits (Other Post-employment Benefits or OPEB). They do not include any amount for pre-funding existing OPEB liabilities. They do, however, include increases in the OPEB liability as an accrued cost due to active employees incrementally earning retirement benefits. Figure 13 shows these benefit costs increasing over the years of this projection.

Over the entire ten-year period, these projections show an overall decline in revenue of 8.2% and an overall increase in benefits costs of 90.1%, even with no inflation higher than the LCFF COLA rate and with attrition or reductions in staff over time equivalent to double the rate of decline in revenue. Since revenue will not go down as fast as enrollment, a likely scenario might be a reduction in staff larger than the decline in revenue but smaller than the decline in enrollment, \textit{i.e.}, estimates of 0.51% revenue decline < 1% staff attrition/reduction < 2.56% enrollment decline. This is the scenario used here.

Note that Pension costs rise faster than other benefits through FY 2024, and then flatten out but remain higher than Health and Welfare costs. This is primarily because of a stepped series of statewide increases in the contribution rates required to fund CalPERS and CalSTRS as a percent of payroll each year. These rates have been announced in advance, and are supposed to stop rising by 2024. However, Pension costs are pegged to current payroll; once the rates reach their maximum, any reductions in payroll will simultaneously reduce Pension costs.
Assumptions:
Revenue assumes declining enrollment at 2.56% per year, LCFF increase of 2.19% per year per student, and other revenues held constant. This results in a decrease in total revenue of 0.51% per year.
STRS is as projected by CSBA through 2023, and PERS is as projected by CalPERS through 2024. Both rise by 1% per year thereafter, as a rough approximation of 2% inflation and 1% staff attrition and reductions at double the rate of revenue decline.
Health and Welfare benefits are according to the HBA through 2019, then increasing at 5.5% per year but with the rate declining over time to 2%. This reflects the Health Research Institute's estimate of employer medical cost growth of 6% for 2019, an assumption that the growth rate of such costs will decline gradually but will remain higher than inflation, and attrition/reduction in staff of 1% per year. OPEB Allocations are as projected in the Actuarial Report of 2017.
Other benefits costs increase by 1% per year, as a rough approximation of 2% inflation and 1% attrition/reductions in staff per year.
As a check of our assumptions, we calculated the effect of increasing FY 2019 benefit costs of $2,062 million by 6.45% per year, which is equivalent to the average of $132.96 million that benefits increased annually from FY 2014 through FY 2018, with compounding of the growth rate, but without adjustment for the additional rising costs of pensions and health care that are known to be coming. The result was a total cost of benefits in FY 2028 of $3,619 million, or $301 million less than shown in the above figure. Pension cost increases alone will be greater than that difference. This suggests that the IAU's cost projections, dire as they are, probably err on the low side.

On the other hand, Health and Welfare costs including OPEB have shown a steady rise and are expected to continue rising beyond the ten-year projection shown here. Because OPEB costs consist of obligations to past employees and obligations being accrued to current employees, they will not go down when revenue declines as easily or rapidly as salary costs can be reduced through reductions in force. Thus, the costs of

15 https://www.federalreserve.gov/faqs/economy_14400.htm
Health and Welfare benefits including OPEB meet both conditions: They make a major contribution to overall cost growth, exceeded only by Pension costs through FY 2024.

Health and Welfare OPEB costs are harder than other cost categories to deal with using short-term cost cutting measures. They are projected to rise for many years to come even if other compensation costs are reduced. Among all costs, these benefits are of the greatest concern in considering the District’s fiscal future.

**The Crowd-Out Effect**

What is the impact of rising Benefits costs on the budget? In Figure 13, above, there is a narrowing gap between total revenue and total benefits costs. This gap represents the bucket of funds from which the District has to pay all other costs that are funded through the General Fund, including Certificated and Classified Salaries. As the graph shows, this bucket of funds will shrink dramatically in size over the next ten years, even under assumptions that are moderately conservative to possibly too optimistic. Below, Figure 14 shows the same projections, interpreted as the *impact* of the rising cost of benefits on all other General Fund expenditures by subtracting benefits from revenue and showing what remains.

**Figure 14. Projected Revenue and Available Revenue after Benefits, FY 2019 – FY 2028**

The curve of available revenue after benefits in the figure above shows an overall decrease of $2.47 billion, or a 45.4% drop from 2019 to 2028. The dollar amount available, under these assumptions, will be $2.97 billion. Note that this is nearly a billion dollars less than the current $3.82 billion for all salaries, and over a billion dollars less than the $4.06 billion projected for all salaries in Figure 12 based on a very small 0.61% annual growth rate. The reduction in force required to cut salaries by that much would also reduce benefits costs, but by a smaller amount due to the continuing cost of OPEB benefits.\(^{16}\)

There are several points to make about these projections:

- The revenue projections are moderately conservative, assuming a constant rate of decline in enrollment and a constant COLA increase in the LCFF rate per-ADA, without any major breakthrough in state funding. Both better and worse scenarios are conceivable.

\(^{16}\) It would be possible to adjust these assumptions to find a level of cuts in staff that would balance the amount available after benefits and the amount spent on salaries. To reach that level of precision, though, the underlying assumptions of these projections should be examined in more detail. We leave that exercise for another time.
• As simple trends, the expenditure projections might seem too optimistic in assuming growth rates that are too low. However, if revenue actually declines as projected, expenditures will be cut by necessity, probably by reductions in force and possibly by changes in benefit cost structures, resulting in moderately lower expenditure growth than shown here. In other words, most expenditure categories will adapt to changes in revenue, some more rapidly than others.

• These projections do not show the District as ‘running out of money’. They do, however, show the District as having to make ever-deeper cuts in non-benefit costs including total salaries.

• Given these assumptions, the size of the crowd-out problem is over two billion dollars a year in ten years.

• If revenue went up by one billion dollars instead of down, a crowd-out problem would still exist, though it would be much less extreme.

Four additional questions about this analysis are worth considering.

First, what increase in state funding per pupil would allow the ‘available revenue’ curve in Figure 14 to stay flat instead of declining? As a back-of-the-envelope calculation, take the $2.48 billion by which that curve declines by FY 2028. Divided by approximately 400,000 students, this would be $6,200 per year per student.

Second, is this situation unique to L.A. Unified? The answer to this is a qualified yes. On the one hand, California’s funding of public education is inadequate, a problem shared by other districts in the state. Furthermore, the costs of health care are rising, a problem shared by not only all districts but all employers in the country who have agreed to provide health care coverage to their employees. On the other hand, L.A. Unified provides greater health benefits to its employees and retirees than most other school districts, and it is the growth in benefits rather than the growth in salaries that is most responsible for the current situation.

Third, why is this crisis threatening the District now? There have been fiscal crises in the past, and the District has survived them. A brief answer is that there is such a thing as a tipping point, and the District appears to be approaching it within the several years. As long as the District’s cost structure is dominated by salaries, as it has been historically, it is possible to respond to a fiscal crisis by reducing staff. However, the cost of benefits has been growing faster than salaries, and is increasingly projected to crowd out salaries. The District has also recently expanded the categories of employees covered by benefits beyond what was historically the case. The increasingly dominant role of benefits in the budget is what is new about the current situation.

Furthermore, there may indeed be major external changes that help resolve this situation for the District, primarily increases in funding per student, reversing planned increases in the pension contribution rates, and decreases in health care costs. Although the District should work to bring these about, they are not guaranteed. It is vital for the District to plan as if those external changes will not happen, while remaining optimistic that they can happen and that the District has a role in making them happen.

Fourth, will this lead to insolvency? The answer to this is a qualified no. Such an outcome will not occur unless and until there is no more revenue available to cover rising fixed obligations such as retiree health benefits. There are many opportunities and many strategies to correct the situation before that point is

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17 https://boe.lausd.net/sites/default/files/08-29-17HealthandWelfarePresentationFinal_0.pdf

18 There is also the fact that the District’s structure—organization and facilities—has historically lagged behind the needs of a growing student population, and considerable funds and effort have been invested over the last two decades in catching up and adapting to such a large enrollment. Now that enrollments are declining, the District faces a different problem that it has not faced before. The IAU does not emphasize declining enrollment in this report, because that does not appear to be the primary driver of the fiscal crisis facing the district. A separate examination of structural adaptations to efficiently and effectively meet the needs of a declining enrollment is worthwhile, and the IAU is conducting preliminary work on such an analysis.
The long-term fiscal problem facing the District is due more to rising benefits costs than to declining enrollments.

In the absence of substantially increased revenues or major reductions in benefits costs, the consequence will be the crowding out of salaries and other costs of providing instruction.

**Recommendation: Focus on the Big Numbers**

The above analysis leads the IAU to the recommendation that the Board and Superintendent should address the District's long-term fiscal problem by focusing on the ‘big numbers’. What does this mean? If the crowd out effect is measured as $2 billion, resolving it would take 200 initiatives saving $10 million each, but only 5 initiatives saving $400 million each. Cost-cutting measures—even the total elimination of spending—in areas other than salaries and benefits simply do not offer enough savings to close the gap.

This is not to say that smaller potential cost-cutting measures should be neglected, since every dollar counts, especially if that dollar can be saved for each student or school. There are also many ways to enhance revenue on a smaller scale—potentially tens of millions of dollars—that are recommended from time to time by various consultants and stakeholders. These cost-cutting and revenue-enhancing ideas are generally constructive, although each initiative should be analyzed to balance its potential savings against the cost of implementing it, both monetary costs, the burden on staff and schools that it might entail, and most importantly how it affects students. The stakes are too high to waste resources and opportunities by being ‘penny wise and pound foolish’—such as by cutting staff to the point of ineffectiveness in offices whose function is to enable cost savings through planning, analysis, control, and information.

Combining strategies smartly to save costs in many relatively small ways can add up to substantial savings. However, the analysis in this section reveals that cost-saving efforts in areas besides salaries and benefits are not likely to produce enough dollar savings to make the essential difference in long-term trends. The recommendation here is that the main focus be on controlling the large numbers that dominate or can dominate projected future expenditures.

In the rest of this section, the IAU offers some suggestions of ways to focus on the bigger numbers. Some are obvious and familiar, while others are more creative or untried. This is not intended to be a comprehensive list of potential solutions, nor is it intended to offer a deep analysis of any of these items. Each suggestion is a beginning for discussion, study, possibly negotiation in some cases, and thoughtful consideration in terms of costs and benefits.

**Pursue Game-changing Public Policy Strategies**

The above analysis of long-term trends is dominated by public policy factors that might appear to be beyond the District’s direct control, i.e., *funding per student, pension contribution rates, and health care costs*. However, given the size and importance of the District (the largest west of the Hudson River, and larger than many states), it might have greater potential influence than has been realized. The District is already active in lobbying in both Sacramento and Washington, D.C., but it might be possible to accomplish more through greater investments, greater publicity, and partnering with other districts or different kinds of entities to bring pressure to bear for change in these three high-stakes areas.

In one of these areas, health care costs, not only school districts but the entire country faces a profound crisis over the next decade unless something is done nationally to reverse the trend. This crisis threatens the profits of businesses and the livelihoods of everyone. That is an extremely wide base of support for change to avert the crisis, so it is virtually certain that this issue will be resolved, and resolved with or without
input from L.A. Unified. However, there is enough disagreement about how to do it that the issue might not get resolved until the situation becomes much more painful than it already is. That might be too late for L.A. Unified to ride out the storm, so it makes sense to take action earlier rather than later.

**Control Growth in Major Benefit Costs**

Given the projected growth of costs illustrated in Figure 13, it is important not only to cut costs now but to control and reduce growth in fixed costs, especially the cost of OPEB Health and Welfare benefits. This area was discussed at length in the IAU’s 2017 report, so it is not necessary to go into detail here. Briefly, that report recommended pursuing multiple strategies for reducing OPEB costs, and described them in terms of tradeoffs between impact and difficulty.

Although OPEB costs will continue to rise for many years even if staff levels are reduced, reducing staff levels will slow the growth of OPEB costs in the future. Reductions in force will also reduce current expenditures on salaries, health benefits, and pension contributions for employees. This is a high-impact strategy, but its human cost is a natural matter of concern.

There are strategies to reduce the human cost of staff reductions, although some of them involve spending money now to avoid spending money later. A first option should be to slow down or refrain from hiring replacement, and let natural attrition reduce staff sizes. Whether the District’s attrition rate is sufficient to achieve any staff reductions needed will have to be the subject of a separate study. It will depend on the reduction target, which in turn will depend on expected revenue and other cost-cutting strategies. Another option might be an early retirement incentive, which the District has used before. This could save or cost money, depending on the ages of those who choose to retire and thus the pattern of OPEB costs they are likely to incur. Again, a separate study is needed to estimate these tradeoffs.

Cutting staff is an incomplete solution to the crowd out problem described above. It doesn’t cut salaries proportionately to the number of positions cut, because the cuts tend to disproportionately impact those employees with less seniority, i.e., lower salaries. It also doesn’t cut benefits as much as it cuts salaries, because a substantial fraction of benefits go to retirees, and some of the current staff who are affected by cuts will choose to take retirement as well. However, cutting staff will slow the growth in OPEB costs over time.

Reductions in wage rates, unlikely and undesirable, would have no effect on health costs, including OPEB, but would reduce pension costs as well as total salaries. However, note that holding wage rate increases below the rate of inflation is equivalent to reducing real wage rates. This would effectively reduce costs in the short term, but its impact would be minor because benefit costs are expected to rise faster than any realistic inflation rate for the foreseeable future.

Note that most of these require negotiation and thus cannot happen immediately. However, it is important to discuss them because *one or more will happen sooner or later* unless revenue increases as fast as benefit costs. Decreasing staff is the obvious first choice, and is typically included as an option in a Fiscal Stabilization Plan, but its impact on benefits might not be substantial enough to stop the cost growth portrayed in this analysis. Table 8 lists several cost cutting options that affect salaries and benefits now and in the future in different ways.

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Table 8. Major Cost Cutting Options

<table>
<thead>
<tr>
<th>Action</th>
<th>Effect on Current Expenditures</th>
<th>Effect on Future Expenditures</th>
<th>Effect on OPEB Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Decrease staff</td>
<td>decrease</td>
<td>decrease and reduce growth</td>
<td>very small decrease now and reduce growth</td>
</tr>
<tr>
<td>Decrease real wages</td>
<td>decrease</td>
<td>decrease but may create future growth pressure</td>
<td>none</td>
</tr>
<tr>
<td>Decrease active employee benefits</td>
<td>decrease</td>
<td>decrease</td>
<td>none</td>
</tr>
<tr>
<td>Decrease retiree benefits</td>
<td>small decrease</td>
<td>large decrease and reduce growth</td>
<td>large decrease</td>
</tr>
<tr>
<td>Decrease retiree eligibility</td>
<td>small decrease</td>
<td>large decrease and reduce growth</td>
<td>large decrease</td>
</tr>
<tr>
<td>Decrease real health plan costs</td>
<td>could be small or large decrease</td>
<td>large decrease and reduce growth</td>
<td>large decrease</td>
</tr>
</tbody>
</table>

Build More Flexibility into Major Contracts

This report shows that the biggest risk to the District’s fiscal status lies in rising fixed costs that cannot be modified quickly or early enough to avoid an inability to pay them with available revenue. One strategy to reduce this risk is to start building more flexibility into major contracts, so that the fixed obligations they represent can be modified when circumstances change. This could prove valuable, not only in case of declining revenue or rising costs, but in case of unexpectedly rising revenue or lower costs.

This is close to being a universal strategy, although it is often neglected in times of financial plenty or in stable, low-risk environments. However, when there is considerable uncertainty about future revenues and costs, the flexibility to make decisions now that can be changed in the future is valuable. This is why financial markets place a price on options, i.e., the value of making a tentative decision now and putting off a final decision until more information is available.

Unfortunately, this strategy often does cost money in the short term. A contract with built-in flexibility generally costs more than a contract with guaranteed terms. Thus, when the District is trying to cut costs in the short term, it may be tempted to make long-term agreements with fixed terms that cost less in the beginning than agreements with options, or flexible terms. That would not be an optimal choice, considering the adverse long-term trends and uncertainties described in this report.

The option strategy suggests avoiding long-term contracts when a short-term alternative is available and somewhat equivalent, at a cost that is appropriate for the added flexibility this entails. This strategy suggests pushing in the direction of more flexibility in labor contract negotiations as well as other major contracts.\(^{20}\) Because of the ‘lowest credible bid’ requirement in awarding contracts, and the fact that flexible contracts are likely to cost more in the short term in spite of their potential for long-term savings, the District’s intention to pay for flexibility will probably have to be written into requirements in advance of bidding, not added as an afterthought.\(^{21}\)

By looking at the long-term trends and not just the short-term budget deficit, the District can make choices that allow fixed obligations to be more flexible in case projections turn out to be too optimistic.

\(^{20}\) In theory, this risk-reducing strategy might take the form of offsetting lower permanent salary increases with higher bonuses and reopeners. Such bargaining details are beyond the scope of this report, and are mentioned here only as an acknowledgement of possibilities and not as a specific recommendation for any negotiation.

\(^{21}\) An economist might point out that there is a market for risk, so the decision can be split. The District might issue a contract to the lowest credible bidder for a specified action without options, and simultaneously issue an option contract (like buying an insurance policy) in which it pays a premium for someone else to cover the risk of having to change the primary contract under certain conditions. This is already done in some areas, but it might be considered more broadly.
Avoid the Big Mistakes

Given the size of L.A. Unified, it is not surprising that the District has at times made highly public, embarrassing, and costly spending mistakes. These mistakes have used up resources that could otherwise have been spent more effectively. Some examples include:

- Apple iPads (2013),
- the payroll system (2007),
- the Belmont campus (late 1990s through early 2000s), and
- various litigation settlements related to failures of oversight.

Big mistakes such as these are a triple burden on the District. First, they create large unplanned costs (which remains true even if partially recovered later through litigation or negotiation). Second, they distract leadership attention from the core job of educating students. Third, they continue to reinforce an already negative view of the District among the media and the public, which can further reduce enrollment and reduce voluntary supports from the public and donors.

Another possible example has not been as publicly recognized but represents one of the reasons that the District faces fiscal challenges in coming years: The District has made decisions about employee benefits in the past that have created costs continuing to the present day and growing into the future. To be clear, benefits are negotiated, and are part of a total compensation package that includes salaries. So this is not ‘wasted’ money so much as money that the District agreed to and committed in the past without completely counting the cost in the future, making those costs hard to control now. Difficult decisions must be made about existing commitments, but the more important point here is that the District must avoid making more such decisions, with future cost growth that is not considered as a cost at the time of making the decision.

Some helpful steps would include introducing costly changes on a limited basis, as pilot tests, rather than all at once; demanding more diligence and more information before making major commitments; and maintaining the organizational capacity to conduct such diligence, provide such information, and carry out the burden of oversight necessary to protect students and others within the District’s responsibility from costly harm.

Every organization makes mistakes, and large organizations entail the risk of making big mistakes. Success in a risky environment lies not simply in achieving gains but also in avoiding losses. In various fields from investing to baseball, it is the errors and giveaway pitches that can undermine an otherwise winning performance. With L.A. Unified facing unfavorable fiscal trends for a decade or more into the future, it is vital that the District exercise special caution about the future consequences of present decisions.

Summary

This section has shown that long-term growth in major fixed costs, predominantly employee and retiree benefits, is the main driver of the District’s fiscal outlook, conditioned by but not caused by declining revenue. This is not to say that a deficit is projected into the future, since such a state of affairs cannot exist; the District must balance its books on a regular basis or forfeit control.

Altogether, expenditures have risen over the last several years in spite of declining enrollment. This has been possible because revenue has climbed substantially before flattening, due to higher LCFF rates. As a result, the District has been spending more each year per enrolled student, which would appear to be a good thing as long as the funds are available and spent wisely and effectively. However, the rate of

22 http://articles.latimes.com/2010/jul/01/local/la-me-0701-lausd-payroll-20100701
https://www.thenation.com/article/school-wasnt/
increase per enrolled student will now slow with the fulfillment of LCFF unless there are further increases in state funding, while the cost of benefits will grow even without more enrolled students. If these trends continue, the growth in benefit costs will crowd out the resources available for other expenditures including salaries.

One or more of the following will happen within the next three to ten years:

- revenue will increase substantially;
- pension contribution rates will return to previous lower levels;
- staff levels will be reduced substantially (more than proportional to enrollment decline, causing class sizes to increase);
- OPEB health costs will be cut (or at least their growth will be stopped), even for existing retirees and employees with accrued benefits; and/or
- the District will become subject to County and State intervention to prevent an ongoing actual deficit (as opposed to a budgetary deficit).

Clearly, it would be better to get higher funding per student, pay lower pension contribution rates, and live in a society with lower (or slower growing) health care costs. But none of these is guaranteed, which means costs must be controlled in some other way. In this section, the IAU recommends focusing on the bigger numbers, i.e., not becoming too preoccupied with small cost-cutting measures while ignoring the major trends dominating the fiscal outlook for at least the next ten years.

This recommendation to focus on the big numbers includes the following suggestions:

- pursue game-changing public policy strategies;
- control growth in major fixed costs;
- build more flexibility into major contracts; and
- avoid the big mistakes.

These are all feasible suggestions. If pursued early enough and vigorously enough, they are big enough to change the long-term fiscal outlook of the District from the projections in this section to a more stable, manageable scenario. However, even this more benign scenario would not be enough to achieve the District’s educational goals, which is the point discussed in the next section.
SECTION FOUR: THE MISSION PERSPECTIVE

Section Two of this report described the District’s fiscal challenge as evidence of the need for better long-term strategic financial planning. When spending cuts become necessary, as has been the case in most recent fiscal years, they tend to be opportunistic and limited to only those cuts that can be taken with relatively short notice instead of being deliberate and integrated with other decisions focused on implementing the District’s strategic plan. The IAU recommended creating a long-term strategic financial plan to guide budget development, and treating the Fiscal Stabilization Plan as a true contingency plan instead of a strategic planning instrument.

Section Three of this report described the District’s fiscal challenge as the result of the long-term trends of flat to declining revenues and the rising share of expenditures devoted to fixed costs, especially benefits costs. The problem with this is not that the District will spend more than its revenue, which is prevented by public policy and governance mechanisms, but that the District will face a shrinking pool of funds from which to pay for all other costs besides benefits. The IAU recommended using a variety of strategies to increase revenues and cut costs, and to focus on the big numbers that will dominate the budget in coming years, especially OPEB costs.

This section takes a different approach to understanding the District’s fiscal challenge. That approach is to recognize that even if the short-term and long-term budget problems described above were somehow resolved, and the threat of a fiscal deficit eliminated, the District would still have a deficit in terms of accomplishing its mission. In other words, it is impossible to specify a previous fiscal year’s budgeted spending level that would be adequate to the task, one the District could return to if only revenues permitted. This is an argument against being complacent when the budget is balanced, and against focusing so much on the threat of a fiscal deficit that the magnitude of the unmet educational challenge is ignored. In this context, the IAU recommends finding ways to transform educational productivity. (It is important to keep in mind that productivity does not mean asking people to ‘work harder’! It means finding ever more creative ways to accomplish more of the educational mission of the District with fewer resources, or at least without increasing expenditures.)

Mission-Fiscal Distress

Rather than use terms like budget deficit and balanced budget to discuss this problem, we introduce the term mission-fiscal distress and define it as achieving unsatisfactory results while apparently consuming all available resources.

Mission-fiscal distress is found by looking at results and comparing them to the results implicit in the mission. This does not mean comparing new results to previous results or one district’s results to another district’s results. Both of these comparisons can at times encourage complacency. However, when results do not compare favorably with the past or with other districts, that almost certainly means they are falling short of this district’s educational mission.

There is plenty of evidence that the educational results achieved by L.A. Unified are unacceptable. These points are familiar to most readers, but some examples are listed here to complete the point:

- L.A. Unified students score below the California average on the Smarter Balanced Assessment (SBAC). On average, L.A. Unified students scored lower than the statewide average in both Math and English Language Arts (ELA), and in almost every subgroup. Overall, about nine percent fewer L.A. Unified students than statewide students scored as meeting or

exceeding standards in ELA, and about eight percent fewer scored as meeting or exceeding standards in Math. (See Table 9.)

- **Black and Hispanic students, English Learners, and economically disadvantaged students in L.A.** Unified score far below other L.A. Unified students on the SBAC, and in some cases far below statewide averages for students in the same subgroups. These statistics are also shown in Table 9. In ELA, only about 22% of Black students and only about 34% of Hispanic students met or exceeded standards. This stands in contrast to about 66% for White students and about 74% for Asian students. In Math, these results were about 19% for Black students, 24% for Hispanic students, 57% for White students, and 70% for Asian students. Among English Learners, less than 4% met or exceeded standards in ELA and about 5% met or exceeded standards in Math. Not only are these English Learner outcomes much lower than for other District students, they are low compared to the statewide average for English Learners at about 12% for ELA and 12% for Math.

- **For the class of 2016, 40.5% of students in the four-year graduation cohort were considered to be prepared for postsecondary education.**25 These rates vary dramatically by subgroup.
  - 16.6% of English learners in the four-year graduation cohort were considered to be prepared for postsecondary education.
  - 11.5% of students with disabilities in the four-year graduation cohort were considered to be prepared for postsecondary education.
  - 29.8% of African American students in the four-year graduation cohort were considered to be prepared for postsecondary education.
  - 70.9% of Asian students in the four-year graduation cohort were considered to be prepared for postsecondary education.
  - 38.9% of Hispanic students in the four-year graduation cohort were considered to be prepared for postsecondary education.
  - 47.1% of White students in the four-year graduation cohort were considered to be prepared for postsecondary education.

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25 California School Dashboard (2017). https://www.caschooldashboard.org. The California Department of Education measures College/Career readiness using a variety of indicators such as scores on AP exams, completion of the UC/CSU a-g requirements, completion of the CTE pathway, meeting standards on the Smarter Balanced Summative Assessments. For more information about CDE’s College/Career Indicator, see https://www.cde.ca.gov/ta/ac/cm/ci.asp.
These statistics show L.A. Unified as lagging behind California averages, which are not stellar. And the differences among subgroups indicate continuing inequities. Given that the District spends virtually all it receives, these results testify to mission-fiscal distress.

L.A. Unified faces a dilemma. On the one hand, the District carries an unconditional responsibility to educate the children within its boundaries. On the other hand, the District receives severely inadequate streams of funding to cover the true cost of educating these children.

This dilemma might be resolved at any time by the state dramatically increasing its funding of K-12 education, perhaps by 100%, if the District could use those resources well. That seems unlikely to happen soon, although pressure to make it happen should be vigorous and ongoing.

It might seem that the dilemma could be resolved by a public policy change eliminating the concept of a school district as bearing primary responsibility for the students within a geographical boundary, and opening up all K-12 education to a fully competitive market among providers. This would result in inequities if it happened without designating a default institution to take responsibility for students whose needs are not adequately met by any market providers, i.e., a provider of last resort. That provider would have to be funded adequately for the needs of the students who end up there. Letting the money follow the child, at current funding rates for special needs students, would leave that provider of last resort with a deficit that could only be met by subsidizing it from other providers or by increasing funding. In other words, this would not solve the underlying problem, and seems unlikely to happen.

What can be done? It is not the District's primary job to solve society's lack of commitment to public education, although it appears that one source of that lack of commitment arises from perceptions that the District fails to make good use of the resources it has. It is not acceptable to cut the mission to fit the budget (see Appendix B for a comment on the inherently arbitrary nature of a budget), even if that seems to ward

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Table 9. Smarter Balanced Assessment (SBAC) Results[^26]

<table>
<thead>
<tr>
<th></th>
<th>ELA LAUSD</th>
<th>ELA California</th>
</tr>
</thead>
<tbody>
<tr>
<td>Met or Exceeded Standards</td>
<td></td>
<td></td>
</tr>
<tr>
<td>All</td>
<td>39.6%</td>
<td>48.6%</td>
</tr>
<tr>
<td>Female</td>
<td>44.9%</td>
<td>53.9%</td>
</tr>
<tr>
<td>Male</td>
<td>34.4%</td>
<td>43.5%</td>
</tr>
<tr>
<td>White</td>
<td>66.1%</td>
<td>64.3%</td>
</tr>
<tr>
<td>Black</td>
<td>21.5%</td>
<td>31.2%</td>
</tr>
<tr>
<td>Hispanic</td>
<td>33.7%</td>
<td>37.3%</td>
</tr>
<tr>
<td>Asian</td>
<td>73.5%</td>
<td>75.5%</td>
</tr>
<tr>
<td>Economically Disadvantaged</td>
<td>34.0%</td>
<td>35.5%</td>
</tr>
<tr>
<td>English Learners</td>
<td>3.6%</td>
<td>12.1%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Math LAUSD</th>
<th>Math California</th>
</tr>
</thead>
<tbody>
<tr>
<td>All</td>
<td>29.9%</td>
<td>37.6%</td>
</tr>
<tr>
<td>Female</td>
<td>29.9%</td>
<td>37.4%</td>
</tr>
<tr>
<td>Male</td>
<td>29.8%</td>
<td>37.7%</td>
</tr>
<tr>
<td>White</td>
<td>57.3%</td>
<td>52.9%</td>
</tr>
<tr>
<td>Black</td>
<td>18.9%</td>
<td>19.0%</td>
</tr>
<tr>
<td>Hispanic</td>
<td>23.7%</td>
<td>25.2%</td>
</tr>
<tr>
<td>Asian</td>
<td>70.3%</td>
<td>72.7%</td>
</tr>
<tr>
<td>Economically Disadvantaged</td>
<td>24.5%</td>
<td>24.6%</td>
</tr>
<tr>
<td>English Learners</td>
<td>5.4%</td>
<td>12.3%</td>
</tr>
</tbody>
</table>

of deficits. Mission-fiscal distress means that there is a gap—perhaps it could be called a deficit—but the
gap that matters is not a gap between revenues and budgeted expenditures. It is the gap between budgeted
expenditures and the expenditures needed to fulfill the District’s educational mission without excuses.

In the short term, the District must ensure that expenditures do not exceed revenues for any extended period
of time. But in the long term, mission-fiscal distress implies that the District must change in ways that
enable it (a) to meet its responsibility to the children and families within its boundaries, and (b) to do so
with the limited resources available to it. In other words, the District must learn to do more with less.

There are many possibilities for increasing revenue or reducing costs without reducing mission fulfillment.
Such steps are an important part of the puzzle. However, what is necessary is to find ways to accomplish
more of the District’s educational mission, not merely to keep the same unsatisfactory pace at lower cost.

The District must find ways to dramatically increase its mission fulfillment that do not increase net costs.

One initial reaction to this claim might be that we’re already doing everything we can with the resources
we have. This argument might be used by an individual to refer to their own work and resources, who is in
fact doing as much as they can or think they can do, and wants more help from the organization. It is the
organization that is not doing everything it can. What is needed is for the organization to find ways to do
more. Some of those ways will involve changing the organization, some will involve learning and applying
different practices, and some will involve finding or creating new tools.

This style of thinking, acknowledgement of need rather than complacency, can motivate a willingness to
contemplate deep change that might not be as attractive without that motivation.

The District is currently engaged in a reimagining initiative that addresses some of the ways that the
District might intentionally change as it moves forward in a social, technological, and economic
environment that has already changed profoundly in recent decades. The IAU is beginning to look at the
details of that initiative, so commenting on them is beyond the scope of this report. However, we point out
that increases in educational effectiveness must come with sustainable price tags within the fiscal
constraints faced by the District. There are many authorities in educational research and practice describing
expensive ways to improve instruction, but fewer offering affordable strategies for districts facing mission-
fiscal distress.

Following are some suggested ways of thinking about deep change that could enable doing more with less.

**Recommendation: Transform Educational Productivity**

The principle identified above, increasing mission fulfillment without increasing net costs, can be identified
with a single word: *productivity*. In this context, productivity is defined as achieving better outcomes for
students with limited resources. It is the converse of mission-fiscal distress.

Unfortunately, this word is sometimes wrongly perceived as meaning to work harder or to require
employees to work harder. Sometimes the motivation of employees is identified as a lever to accomplish
more, which is probably only true when employees are already demotivated for some reason.27 Experiments

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27 According to the two-factor theory of motivation, the factors that lead to employee satisfaction and motivation are
different from the factors that lead to dissatisfaction and demotivation. Herzberg, Frederick; Mausner, Bernard;
in using compensation as a performance motivator for educators have not shown measurable success.\textsuperscript{28} Increasing productivity is not a matter of motivation to work harder. Economists have a different definition:

**Productivity comes from using tools, techniques, organization/collaboration, and human capital.**

Given just about any kind of work, the least productive way to accomplish it is for one person to do it alone and without tools and skills. Starting from that condition, productivity can be increased by adding or improving tools, finding more effective and efficient techniques, working with the right level of collaboration in a supportive organization, and developing skills.\textsuperscript{29} Education has traditionally tended toward the ‘one person working alone without tools’ side of the spectrum, although the skills of the teacher have long been recognized as vital. For education to do more with less in the 21st Century, a revolution in productivity is required, which means more and better tools, more effective practices, more collaboration supported by appropriately sized and designed organizational structures, and more effective development of the skills needed to use the tools and implement the practices.

Some of these changes will result in a larger student-teacher ratio for some grades and subjects, while at the same time reducing the teacher’s workload and allowing more focus on students and instruction. In labor economics, compensation is tied to productivity, such that making workers more productive leads to higher rates of compensation, combined with either increased total output or fewer workers. Increasing student-teacher ratios to cut costs in a budget crisis may be necessary at times, but it is not the same as increasing the productivity of teachers. Increasing productivity through tools, practices, and collaboration in the 21st Century will ideally lead to higher wages for teachers while giving them a less stressful workload that allows them to focus on instruction and learning for more students than before.

Many such changes cannot be done by one district acting alone, but L.A. Unified is in a position to lead rather than follow in this quest. As a large, diverse district with enough schools to provide alternatives to students and families, the District is ideally situated to experiment with innovative practices such as pilot tests. The District is large enough that a meaningful trial will not risk a large fraction of District resources. Pilot tests are recommended unless a practice has been thoroughly tested in other districts, with rigorous research designs in stead of anecdotal evidence. Urgency matters to our students, but so does doing the right thing.

A very few provocative ideas for change are briefly described below. This is not a report on school reform, and it does not claim to offer thorough research on all of the possibilities and alternatives. These ideas are starting points for research and discussion that must take place to make transformational change successful. Starting that discussion sooner rather than later will allow more thorough research, planning, communication, and buy-in for new ideas.

**Technology**

One example of leveraging new technology for educational success is sometimes called the ‘flipped classroom’. Using this method, students watch or listen to lessons at home or in study centers. When they come into school, they participate in group or individual work that might be considered homework in a traditional classroom.\textsuperscript{30} To a large extent, the learning of content can take place outside of a classroom, and a teacher’s time can be focused on working with students on the understanding and application of content. Technology allows for increased flexibility in the flipped classroom approach. If students work on individual tablets or laptops, they can work at their own pace, and teachers have an opportunity to work

with students one-on-one. This can allow for increased class sizes without increasing the workload of teachers or reducing the personal attention received by each student.

A middle school in New York City used a flipped classroom model so that one math teacher could teach 50-100 students at once. The school then used other teachers as reading teachers, so that students, including a large population of English learners, had small group instruction with 10 or fewer students. The students used Chromebooks so that all of them were practicing math problems at their own level; they were able to move on when they were done and able to get individual attention when they needed help. While an academic study has not been completed on this particular model, almost twice as many fifth graders passed their math state exams compared to other neighborhood schools in 2013.31

It is important to note that this example did not consist of introducing Chromebooks in isolation from changes in teaching practice and school organization. It is the integrated application of technology that has the most promise for educational productivity. This is only one example of many, and even more things are becoming possible than have yet been imagined.

**Leveraging the Organization of Students’ Time**

_In education, the most precious resource is not the funds of the school but time in the life of a child. When that resource is squandered, nothing else matters._

What does that have to do with productivity? Given our definition of accomplishing more with less, there may be ways to organize educational time—meaning years of exposure to education, not simply classroom time—that give students more opportunity to learn without increasing net costs. These ideas fall under the categories of technique and organization rather than technology, but the impact on productivity can be just as great.

A child’s educational experience from birth to college is organized and structured not only by classrooms with teachers, but by years and grades of exposure to the educational system. With all of the effort and money put into improving classroom practices and training teachers over the last several decades, the year-by-year organization of learning time is largely unchanged from the early 20th Century. It could almost be described as a lockstep progression through the grades K-12, with only rare exceptions. This is organizationally efficient, but it may not be a highly effective way to structure a child’s learning career.

One example of leveraging student time for greater educational impact while increasing revenue is to expand early childhood programs. That has been discussed at some length in the boardroom and does not need to be explored here. But it should stimulate thinking about other ways to increase educational opportunities for more students without increasing net costs.

One way to make better use of student years and improve student outcomes without increasing the net of costs after corresponding revenue gains would be to look at our populations of students who reach the end of their K-12 careers without having learned enough to graduate, and perhaps without having mastered English. We offer schools and programs for students who reach the end of thirteen years of schooling without graduating, but it would be better for these student to have received help earlier.

Students who stumble on Algebra in 8th and 9th grades will not be able to benefit from more advanced math courses in high school. English learners who have not reclassified as proficient by middle school will have impaire access to the increasingly difficult academic curriculum in later grades. Some disabilities may slow the pace of learning, so that a student who is capable of doing well in eight years of middle to high school is only given the same seven years as everyone else. Each of these examples describes students who would benefit from an extra year of schooling long before they get to the end of 12th grade.

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Such an extra year of schooling would cost money, but it does not violate the productivity criterion stated above because the state will fund that year of schooling. Adding a year of schooling will increase the District’s ADA. The revenue generated by such a student should be enough to cover the cost of that year—if it could be organized efficiently—and also make a small contribution to the overhead of the District.

Of course, the design of such an intervention would have to be carefully considered. Given the known stress that students experience when changing schools, it might be that an extra year of schooling should only be inserted at the seams of the PK-12 years, i.e., between 5th and 6th grade and between 8th and 9th grade, perhaps with a second year of Kindergarten as another possibility. Because of the stigma associated with being ‘held back’ in a grade, it might be advisable to place the program in the student’s new school, not the previous school, so that a grade 8-9 program would reside in the high school and not the middle school, and a grade 5-6 program would reside in the middle school and not the elementary. Rather than keeping the student in the same grade level of content for a second year, a program could be especially designed to meet students’ academic needs, and students with similar needs would be able to go through the experience together. These issues would require research into the impact of additional time on learning, the curriculum and instruction best suited for such programs, the experiences of other districts or states, California’s education code and policies, and how many students with what kinds of needs would be candidates for such a year.

Educational productivity has been researched and discussed for at least fifty years. However, most of that research has focused on what takes place inside the four walls of a classroom with one teacher, rather than looking for ways to redesign the structure of K-12 one grade per year schooling as moving from one teacher and classroom to another. Most of that research also took place before the benefits of information technology began to transform society and open up possibilities for transforming education. The purpose of this discussion is not to recommend a specific kind of program, organization, or technology, but to demonstrate that there are ways to increase the value that students get from education—especially students who are not currently getting the value they need—while either reducing costs or increasing revenue to cover the costs.

**Summary**

L.A. Unified struggles to avoid budget deficits in the short run, and to cope with the long-term trend of rising fixed benefit costs crowding out resources for instruction. However, this third perspective on the District’s fiscal outlook points out that even if these issues are resolved, the District would still be in a state of mission-fiscal distress, defined as achieving unsatisfactory results while consuming all available resources. With mission-fiscal distress, the budget-balancing cost-cutting process can easily lead to complacency when expenditures are reconciled to revenues. In fact, this target level of expenditures is an artifact of years of balancing budgets instead of a thoughtful statement of what it would cost to accomplish the District’s highest goals.

Fulfilling the District’s mission can only be accomplished by increasing revenue—which the District seeks to do but cannot rely on—and/or increasing educational productivity, *i.e.*, using tools/technology, techniques/practices, organization/collaboration, and human capital to transform education without increasing net costs. There are many possible ways to increase productivity. Each requires research and analysis before adoption, but pilot testing ideas provides a way to evaluate results and learn from the experience of implementation before committing the District to full-scale change. Two ideas discussed here are using technology to transform how students learn and how teachers interact with them, and looking for ways to increase student exposure to the learning opportunities they need before they reach the end of their formal schooling years.
SECTION FIVE: CONCLUSION

It has been said that “a district’s first budgetary responsibility is to be fiscally sound.” However, the IAU argues that this is an incomplete rule. The District’s first budgetary responsibility is to make effective and efficient use of available resources for the education of young people. It can only continue to do so by being fiscally sound, but fiscal soundness is not enough. A budget is an instrument for controlling funds, satisfying governance interests, and communicating with the public, but it is also an opportunity to plan and implement a strategic agenda to achieve a mission. As long as the budget development exercise consists of taking the new expected revenue and the previous spending budget, and applying augmentations and cuts piecemeal until a balance is reached, the budget will not be well-integrated into the District’s long-term strategic planning.

To improve short-term budgeting and allow for thoughtful rather than opportunistic decisions, the IAU recommends creation of a long-term strategic financial plan. To cope with the long-term trends of flattening revenue and dramatically rising fixed benefit costs, the IAU recommends focusing on the big numbers that can make a difference, finding ways to limit the growth of fixed costs, building flexibility into long-term contracts, and carefully avoiding the kind of big mistakes that can cost the District large amounts of money needed to serve students. To overcome mission-fiscal distress, the IAU recommends finding ways to transform educational productivity and accomplish more with less.

All of these recommendations are doable. None of them alone will ‘solve’ the entangled puzzle that is the District’s fiscal outlook. However, each of them would make a major contribution to the fiscal health of L.A. Unified and therefore to the high quality and equitable education of all its students.

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APPENDIX A: Findings and Recommendations of Two Previous Studies

This appendix consists of two tables summarizing findings and recommendations from two outside studies of L.A. Unified's fiscal outlook.


Table 1. Key Findings and Recommendations from the Independent Financial Review Panel (2016) 33

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Funding Findings</strong></td>
<td>California's funding per student ranks near the bottom of all states.</td>
</tr>
<tr>
<td><strong>Funding Recommendations</strong></td>
<td>Lobby for more funding from the State.</td>
</tr>
<tr>
<td><strong>Attendance Recommendations</strong></td>
<td>Develop a plan to improve attendance by school and by grade and implement with the goal of improving attendance rates. Implement an aggressive dropout prevention program.</td>
</tr>
<tr>
<td><strong>Staffing and Benefits Findings</strong></td>
<td>Loss of 100,000 students should result in cut of 10,000 staff, but the District increased staff and salary. 56% of staff have reached the maximum salary level. Cutting staff wouldn’t result in desired amount of savings. Only 70% of staff are attending work at least 96% of the time. Increased pension costs due to increasing employer contribution rates in state law. Per FTE, the District’s expenditures for benefits are 9.4% higher than the state average.</td>
</tr>
</tbody>
</table>

**Table 1. Continued**

<table>
<thead>
<tr>
<th>Staffing and Benefits Recommendations</th>
<th>Commit to making proportional staffing reductions in any year where enrollment declines.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Implement actuarially sound early retirement incentive program with clear understanding that most senior staff positions will not be replaced.</td>
</tr>
<tr>
<td></td>
<td>Eliminate the teacher pool.</td>
</tr>
<tr>
<td></td>
<td>Increase expectations for staff attendance and reduce substitute costs.</td>
</tr>
<tr>
<td></td>
<td>Integrate defined benefit pension entitlements with social security for employees who are eligible for both.</td>
</tr>
<tr>
<td></td>
<td>Implement a drug formulary option to save both employees and district money on prescriptions.</td>
</tr>
<tr>
<td></td>
<td>Require staff to pay part of the premium if they choose to add family member coverage, or, alternatively, provide incentives for them not to add them.</td>
</tr>
<tr>
<td></td>
<td>Use the plans offered in the ACA as the standard for retiree benefits coverage.</td>
</tr>
<tr>
<td></td>
<td>Consider going to a 90/10 contribution rate health benefit plan.</td>
</tr>
<tr>
<td></td>
<td>Offer retirees a lump sum payment in lieu of benefits.</td>
</tr>
<tr>
<td></td>
<td>Aggressively review eligibility of employees and family members covered by District health plans.</td>
</tr>
<tr>
<td></td>
<td>Negotiate a cap on District health care expenditures to reflect the decline in the number of students and staff.</td>
</tr>
<tr>
<td></td>
<td>Renegotiate the HBA and freeze all health expenditures for five years.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Business Operations Findings</th>
<th>District has a relatively high level of payroll errors compared to its peers. This could be indicative of lack of adequate controls.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>In 2011-2012 these costs totaled $100 per ADA, $12 more per ADA than the average. The loss in productivity and the expense associated with the claims is a cost the District cannot afford.</td>
</tr>
<tr>
<td></td>
<td>Food services have been encroaching on the General fund consistently.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>More aggressively manage Workers Compensation costs.</td>
</tr>
<tr>
<td></td>
<td>Hire 3rd party consultant to address additional Workers’ Compensation concerns and recommendations.</td>
</tr>
<tr>
<td></td>
<td>Immediately curtail and eliminate any contribution from the General Fund to the Cafeteria Fund.</td>
</tr>
</tbody>
</table>
**Financial Assessment of the District by MGT of America, 2004**

*Table 2. Key Findings and Recommendations from MGT of America’s Financial Assessment of the District (2004)*

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue Findings</strong></td>
<td>The number of students enrolled is not growing. Chartered school enrollment is growing.</td>
</tr>
<tr>
<td>Revenue Recommendations</td>
<td>Leverage bond funds to free up general fund resources for building-related program costs.</td>
</tr>
<tr>
<td></td>
<td>1. Pay for accounting, purchasing, and other staff handling functions related to the bond with bond funds.</td>
</tr>
<tr>
<td></td>
<td>2. Treat purchases made for new facilities as capital costs rather than operating costs and use bond funds to cover them.</td>
</tr>
<tr>
<td></td>
<td>Approve a parcel tax.</td>
</tr>
<tr>
<td><strong>Expenditure Findings</strong></td>
<td>The number of high school students is growing, and their education is more expensive.</td>
</tr>
<tr>
<td></td>
<td>Gas and utility costs are increasing.</td>
</tr>
<tr>
<td></td>
<td>Costs associated with health benefits and workers’ compensation are increasing.</td>
</tr>
<tr>
<td></td>
<td>Subsidizing SPED programs and other District defined programs encroach on the general fund.</td>
</tr>
<tr>
<td></td>
<td>Costs associated with NCLB are beginning to be realized.</td>
</tr>
<tr>
<td></td>
<td>LAUSD staff population is growing while student enrollment remains stagnant.</td>
</tr>
<tr>
<td></td>
<td>LAUSD is in the midst of a $5.9 billion facilities improvement initiative.</td>
</tr>
<tr>
<td><strong>Expenditure Recommendations</strong></td>
<td>Review functional, organizational, and business operations of the District so that future staff reductions of the elimination of positions are done in an informed manner.</td>
</tr>
<tr>
<td></td>
<td>Contain costs associated with health benefits and insurance premiums.</td>
</tr>
<tr>
<td></td>
<td>1. Restructure the benefit package.</td>
</tr>
<tr>
<td></td>
<td>2. Revise eligibility requirements.</td>
</tr>
<tr>
<td></td>
<td>Increase transparency around the budget and improve the budget process.</td>
</tr>
</tbody>
</table>

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APPENDIX B. The Problem of the Arbitrary Budget

When we talk about a budget deficit, or a balanced budget, we are talking about two numbers, Total Revenue and Total Expenditures. The math is simple: in which direction does the inequality point, or are the two numbers equal?

Typically, we treat revenue as determined by factors outside of the budget. Balancing the budget primarily consists of selecting a set of expenditures that satisfies the revenue constraint. There is no real limit to the expenditures we want, so we budget them up to and perhaps a little over the expected revenue, as described in Section Two of this report. The expenditure amount is controlled by the revenue amount.

The revenue amount is somewhat arbitrary. The factors that determine revenue include student enrollment and ADA, student need, state education law and policy, specific state funding decisions, state fiscal health in general, Federal programs, the economy, public opinion, elections, lobbying, leadership, and the momentum of the status quo level of funding.

If expenditures are controlled by revenues, and revenues are somewhat arbitrary, then expenditures are somewhat arbitrary, which also means that deficits are somewhat arbitrary. That does not mean they may be ignored.

This is reinforced by the momentum of budgeting, as described in Section Two. The targeted level of expenditures for a new fiscal year is generally the previous fiscal year’s expenditures plus some desired augmentations. When revenue is expected to be lower than this total, the cutting process begins. The previous budget is the mathematical and psychological benchmark by which we keep track of augmentations and cuts. This would remain true even under most other budgeting approaches.

But the previous year’s level of expenditures was pegged to that year’s revenue, and was benchmarked by comparison to expenditures in the year before that. This flow of links extends one year at a time from far in the past to the present. Each year, there are events and decisions that change the direction of this flow, but the strictness of the revenue constraint and the momentum of the budget tend to make large changes rare. This accumulation of events over time is implicitly embedded in any new budget.

In one sense, an annual budget represents the intentions of the District to carry out an agenda for the year and pay for its costs. In another sense, the targeted level of total expenditures for the new year is an artifact of countless historical decisions and arbitrary factors. No one seriously proposes that the proposed expenditures are enough to fulfill the District’s mission to provide a world-class PK-12 education that equitably and more than adequately prepares the children of Los Angeles and surrounding cities for college and career in the 21st Century. The number we attach to those expenditures is far less than the real need, and the level where that number ends up is arbitrary rather than having intrinsic meaning as a critical threshold level of meaningful spending.

The problem with this is that when we balance a new budget by making incremental augmentations and cuts to an artifact of previous budgets, so that expenditures approximately equal revenues, we are satisficing, not achieving. It becomes tempting to cut the mission to fit the funding, and then celebrate when we are able to cut it enough to avoid a fiscal deficit.

Always planning expenditures to fit expected revenues is legally necessary, but is an inadequate mindset. This Procrustean approach can limit our progress to incremental changes in the status quo, and leave us complacent and satisfied before our mission is fulfilled. In that context, there will emerge disagreements about where to make changes and cuts, with many disagreeing parties asserting rightfully that they are being left behind with inequitable and inadequate resources even when the whole organization balances its books. An anticipated fiscal crisis can offer opportunities to break out of this pattern, make thoughtful changes, creatively seek underutilized resources, and develop new approaches and tools.
APPENDIX C: Some Budgeting Approaches

This appendix summarizes some of the common budgeting approaches in public financial management, as described in the Encyclopedia of Education Economics and Finance. By way of introduction, the following points are useful:

- There is no 'one size fits all' best approach.
- A budget is a solution to certain kinds of problems; the choice of a budgeting approach for a specific organization should reflect an understanding of the problems the budget is supposed to help solve in that particular organization. For example, one approach might help to increase central control in an organization perceived as rife with waste, fraud, and abuse, while another approach might help to empower sites to make their own decisions in an organization perceived as being too centralized.
- Approaches may be combined, especially in a complex organization where one approach addresses problems encountered at one level or in one area of the organization, and another approach addresses problems at a different level or area. For example:
  - one approach might be useful for school site budgeting while another approach might be needed simultaneously for long-term planning such as for facilities or information technology projects, and
  - one approach might be required for compliance purposes while another approach might be vital for strategic planning.
- One of the main differences between approaches is the relative cost to implement them (or at least to implement them well). A perfectly comprehensive budgeting system might cost so much as to 'break' the budget, while an austere budgeting system that minimizes its own administrative costs might be so weak as to allow wasteful spending in the rest of the organization. Finding the right balance is important, and that balance may change over time.

Not all the approaches described in the Encyclopedia are included here. These appear to be most relevant in considering how L.A. Unified should think about budgeting:

**Line-Item Budgeting**

"The purpose of line-item budgeting is to describe projected expenditures, by category, and the amount allocated to each category. ... Line-item budgeting is a straightforward approach to budgeting that makes it easy to prepare, administer, and explain a budget; makes it easier to monitor revenues and expenditures; and allows flexibility in the degree of control an organization chooses to provide a given unit. Additionally, it accommodates the analysis of trends relative to purchases and costs. A criticism of this approach is that it does not facilitate long-range planning, nor does it allow monitoring of expenditures associated with a particular program, area, or administrative function."

The status quo budget process in L.A. Unified primarily follows the line-item model with incremental budgeting changes, with some features of site-based and program budgeting. This provides greater detailed control over spending and consumes fewer staff resources than alternative models, but—as noted in the above quotation—is not well-suited to long-range planning.

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Incremental Budgeting

"...uses the previous year's budget as a starting point, focusing on individual line items, which are then increased or decreased in equalized increments. Strengths of this approach are consistency in funding across units or functions, easily identifiable changes in funding, and low levels of uncertainty. A criticism of this approach is that projected funding is based on previous year allocations, which can encourage indiscriminate spending to avoid lowered funding allocations for the following year. Additionally, decision making with this approach is minimal given that administrative units are not required to justify existing expenditures nor are program-related needs, activities, or outcomes considered. ...this approach limits the implementation of substantial changes to reflect a change in an organization's vision or priorities."

Capital Budgeting

“...focuses on the budgeting of an organization’s current and future benefits to improve and/or maintain long-term investments (assets) such as facilities, equipment, and land for a period of time usually more than a year. … Capital budgeting decisions, once made, are not easily changed.”

Certain areas of District management must use capital budgeting, notably facilities and information technology. However, it is not appropriate for annual budgeting of operating expenditures.

Performance Budgeting

"...placing emphasis on organizational outputs such as activities or services. Programs are presented in sufficient detail to describe and link goals and objectives (program components) with related activities and services (outputs) to measurable intended results. Measures or performance indicators are identified for each activity or service. Federal, state, and local governments use performance budgeting."

"More school districts are choosing to use performance budgeting in response to federal and state-level initiatives tied to performance pay, although past efforts to use performance pay in education have met with limited success. Performance budgeting does not determine whether the intended activities or services are appropriate for the program's goals and objectives, nor does it accommodate long-range planning. This form of budgeting tends to be more suitable for standard or routine activities and may be used in conjunction with one of the other budgeting approaches discussed in this section."

Performance budgeting can be used in areas of District management that deal with routine activities such as transportation and food services. However, it is not appropriate to apply to the costs associated with instruction, where outputs are measured in multiple dimensions, often imprecisely, and where specific inputs are linked to many outputs and specific outputs are linked to many inputs.

Site-Based Budgeting

"...districts use building-specific data to generate a formula or system for reallocating funding and responsibility for some budgeting decisions to the school-site level. Building administrators are accountable for planning and developing the budgets for their schools. Strengths of this approach are its potential for increased decision making at the levels of service delivery ... and increased participation of faculty, staff, and community members in decision-making processes. The degree to which site-based staff and the community actually participate in the decision-making process is based on which model of shared decision-making the administrators adopts or whether he or she chooses to use shared decision-making. A criticism of this approach is the conflict that may arise among individual staff members or departments over resource allocation. Additionally, districts may have more difficulty ensuring cross-district equity in educational programming. Site-based budgeting may be combined with one of the other common budgeting approaches listed in this section."
**Zero-Based Budgeting**

“… entails starting the budgeting process, each year, from the beginning (zero) to identify projected revenues and proposed expenditures and to justify the costs for proposed program activities and services. … The purpose of zero-based budgeting is to achieve efficiency and effectiveness by annually reviewing a program to eliminate any components that are no longer considered as best practice and that are not realizing the intended benefit. … The strength of this approach is that it provides administrators with detailed information in the form of decision packages, which simplifies the decision-making process. This is a resource-intensive model that requires a good portion of an organization’s staff time for planning and completion of paperwork.”

**Program Budgeting or Program and Planning Budgeting**

"...includes aspects of line-item budgeting and focuses on the program as a whole rather than program elements such as inputs, activities, or outcomes. .... Program budgeting provides a flexible form of budgeting and supports long-range planning. However, it does not offer the detail of line-item budgets. Additional criticisms of this approach are the absence of organization-wide agreement on its goals and objectives and the lack of data management systems that are adequately designed to provide appropriate data for program planning and budgeting. This approach may be combined with any one of the common budgeting approaches.”
APPENDIX D: GFOA Best Practices

This appendix lists the recommendations of the Government Finance Officers Association (GFOA) in several areas. These are:

- Best Practices in School District Budgeting
- Establishment of Strategic Plans
- Long-Term Financial Planning
- Departmental Presentation in the Operating Budget Document

The GFOA website (http://www.gfoa.org/best-practices) provides recommendations in these and many more areas.

There are many good ideas in the documents copied below, and the recommendations by the IAU in this paper include many but not all of them. However, we are not endorsing all these GFAO 'best practices' as the correct practices for LA Unified at this time. What we recommend are feasible, balanced steps that are necessary to achieving fiscal responsibility in the long term. In contrast, the scope and complexity of these practices would require substantial time and costly administrative resources to implement fully.

The GFOA is an organization focused on the financial management perspective, not necessarily the top management strategic perspective or the educational effectiveness perspective. Creating a 'best' organization from the perspective of professional financial officers may be a worthy goal, but it should not occupy so much attention that the educational goals of the District are neglected, postponed, or distorted.

There are some limitations to these recommendations. Some of them are inconsistent with each other. For example, they differ about where goal-setting belongs in the sequence of concrete steps they recommend. Other practices are both obvious and vague, such as the recommendation that instructional practices should be based on research. These lists do not provide much help in transforming an existing system that is already and constantly in a state of change, as opposed to starting from a blank slate in a new system or one that does not already have a strategic plan and a massively complex budget.

Nevertheless, this collection of ideas appears to be the best roadmap available provided it is followed thoughtfully, not taken too literally as the only right way to do things. The IAU's recommendations in this paper are intended as a way to get started, and may be supplemented with additional ideas or practices from these GFOA lists. One of the most important points common to both the IAU and the GFOA recommendations is that strategic financial planning requires the full commitment of the organization from the top down. It is not something financial managers or budget offices can do on their own.
Best Practices in School District Budgeting

Source: http://www.gfoa.org/best-practices-school-district-budgeting

Background:
GFOA has developed a series of Best Practices in School Budgeting, which clearly outline steps to developing a budget that best aligns resources with student achievement goals. This document summarizes the key themes from those Best Practices which are available at www.gfoa.org.

The budgeting process presented in these Best Practices is focused on optimizing student achievement within available resources. It encompasses a complete cycle for long-term financial planning and budgeting, including planning and preparing to undertake the budget process, developing a budget, evaluating how the budget process worked, and adjusting accordingly. Within this cycle, the district’s instructional priorities provide a guide for decision-making.

Recommendation:
GFOA recommends that all districts go through the following steps as part of their planning and budgeting process.

Step 1. Plan and Prepare.
The planning and budgeting process begins with mobilizing key stakeholders, gathering information on academic performance and cost structure, and establishing principles and policies to guide the budget process.

A. Establish a partnership between the finance and instructional leaders. A collaborative process increases the likelihood that the decisions made will be supported after the budget process is over.
B. Develop principles and policies to guide the budget process. Budget principles and policies formalize standards and fundamental values that should govern the budgeting process.
C. Analyze current levels of student learning. The current state of academic performance must be assessed to determine what course of action to take.
D. Identify communications strategy. The budget process should include a plan to inform participants, stakeholders, and the general public about how the budget process works, why each decision was made and how to provide input in the process.

Step 2. Set Instructional Priorities.
The budget needs to be rooted in the priorities of the district. Intentionally created instructional priorities provide a strong basis for developing a district’s budget and strategic financial plan, as well as presenting a budget document.

A. Develop goals. Goals should be thoughtfully developed and structured to be specific, measurable, and reasonable in order to provide a strong foundation for the budget process.
B. Identify root cause of gap between goal and current state. By finding root causes of problems, a district can identify the most effective solutions to achieving its goals.
C. Research & develop potential instructional priorities. The district’s instructional priorities should be informed by practices proven by research and also be limited in number to focus on items critical to optimizing performance.
D. Evaluate choices amongst instructional priorities. A district needs to weigh its different options for achieving its goals against one another in order to focus on those with the greatest potential for student achievement impact.
Step 3. Pay for Priorities.

Current resources and expenditures must be thoroughly analyzed in order to find capacity to pay for top instructional priorities.

A. Apply cost analysis to the budget process. A cost analysis and staffing analysis are essential to identifying how the district might allocate its limited resources.

B. Evaluate & prioritize use of resources to enact the instructional priorities. Instructional priorities need to be thoroughly quantified as a first step to determining how much money is needed to implement the priorities and where that money will come from. Trade-offs need to be weighed to examine whether the costs, financial or otherwise, of implementing an instructional priority are viable.

Step 4. Implement Plan.

The "strategic financial plan" is the long-term road map for implementing the district's instructional priorities. A "plan of action" describes how the strategic financial plan will be translated into coherent actionable steps.

A. Develop a strategic financial plan. A strategic financial plan provides a three to five-year perspective on how the district will pursue its instructional priorities and how success will be determined.

B. Develop a plan of action. Roles and responsibilities for implementing the strategic financial plan should be made clear for greater accountability.

C. Allocate resources to individual school sites. Resources have the most direct impact at school sites and should be allocated transparently and consistent with the district's overall strategy.

D. Develop a budget presentation. A budget document needs to be well organized and also clearly lay out the challenges the district is facing and how the district's strategies and financial plan will address these challenges.

Step 5. Ensure Sustainability.

The planning and budgeting process should be one that can be replicated in the future in order to ensure the district remains focused and plans accordingly for reaching its student achievement goals.

A. Put the strategies into practice and evaluate results. To ensure timeliness and accountability, the district should establish a system to implement the plan and monitor its progress while making necessary adjustments to stay on track.

**Establishment of Strategic Plans**

Source: [http://www.gfoa.org/establishment-strategic-plans](http://www.gfoa.org/establishment-strategic-plans)

**Background:**

Strategic planning is a comprehensive and systematic management tool designed to help organizations assess the current environment, anticipate and respond appropriately to changes in the environment, envision the future, increase effectiveness, develop commitment to the organization’s mission and achieve consensus on strategies and objectives for achieving that mission. Strategic planning is about influencing the future rather than simply preparing or adapting to it. The focus is on aligning organizational resources to bridge the gap between present conditions and the envisioned future. While it is important to balance the vision of community with available resources, the resources available should not inhibit the vision. The
organization’s objectives for a strategic plan will help determine how the resources available can be tied to the future goals. An important complement to the strategic planning process is the preparation of a long-term financial plan, prepared concurrently with the strategic plan. A government should have a financial planning process that assesses the long-term financial implications of current and proposed policies, programs, and assumptions. A financial plan illustrates the likely financial outcomes of particular courses of actions.

Strategic planning for public organizations is based on the premise that leaders must be effective strategists if their organizations are to fulfill their missions, meet their mandates, and satisfy their constituents in the years ahead. Effective strategies are needed to cope with changed and changing circumstances, and leaders need to develop a coherent and defensible context for their decisions. National Advisory Committee on State and Local Budgeting (NACSLB) Recommended Practices provide a framework for financial management, which includes strategic planning.

**Recommendation:**

GFOA recommends that all governmental entities use some form of strategic planning to provide a long-term perspective for service delivery and budgeting, thus establishing logical links between authorized spending and broad organizational goals. While there is not a single best approach to strategic planning, a sound strategic planning process will include the following key steps:

1. **Initiate the Strategic Planning Process.**
   
   It is essential that the strategic plan be initiated and conducted under the authorization of the organization’s chief executive (CEO), either appointed or elected. Inclusion of other stakeholders is critical, but a strategic plan that is not supported by the CEO has little chance of influencing an organization’s future.

2. **Prepare a Mission Statement.**
   
   The mission statement should be a broad but clear statement of purpose for the entire organization. One of the critical uses of a mission statement is to help an organization decide what it should do and, importantly, what it should not be doing. The organization’s goals, strategies, programs and activities should logically cascade from the mission statement.

3. **Assess Environmental Factors.**
   
   A thorough analysis of the government’s internal and external environment sets the stage for an effective strategic plan. A frequently used methodology for conducting an environmental assessment is a "SWOT" (Strengths, Weaknesses, Opportunities, Threats) analysis. Strengths and weaknesses relate to the internal environment, while analysis of opportunities and threats focuses on the environment external to the organization.

   Local, regional, national, and global factors affecting the community should be analyzed, including (a) economic and financial factors, (b) demographic trends, (c) legal or regulatory issues, (d) social and cultural trends, (e) physical (e.g., community development), (f) intergovernmental issues, and (g) technological change.

   Also, a government should develop mechanisms to identify stakeholder concerns, needs, and priorities. Among the mechanisms that might be employed to gather such information are (a) public hearings, (b) surveys, (c) meetings of community leaders and citizens interest groups, (d) meetings with government employees, and (e) workshops for government administrative staffs and the legislative body.

4. **Identify Critical Issues.**
   
   Once the environmental analysis has been completed, the next step is to use the resulting information to identify the most critical issues. Issue recognition should reflect stakeholder concerns, needs, and priorities as well as environmental factors affecting the community.
(5) Agree on a Small Number of Broad Goals.

These written goals should address the most critical issues facing the community. It may be necessary to define priorities among goals to improve their usefulness in allocating resources.

(6) Develop Strategies to Achieve Broad Goals.

Strategies relate to ways that the environment can be influenced (internal or external) to meet broad goals. A single strategy may relate to the achievement of more than one goal. There should be a relatively small number of specific strategies developed to help choose among services and activities to be emphasized. Use of flowcharts or strategy mapping is encouraged in the design of strategies. To optimize the success of these strategies, opportunities should be provided for input from those who will be affected.

(7) Create an Action Plan.

The action plan describes how strategies will be implemented and includes activities and services to be performed, associated costs, designation of responsibilities, priority order, and time frame involved for the organization to reach its strategic goals. There are various long-range planning mechanisms available to enable organizations to clarify their vision and strategy and translate them into action.

(8) Develop Measurable Objectives.

Objectives are specific, measurable results to be achieved. Objectives and their timelines are guidelines, not rules set in stone. Objectives should be expressed as quantities, or at least as verifiable statements, and ideally would include timeframes.

(9) Incorporate Performance Measures.

Performance measures provide an important link between the goals, strategies, actions and objectives stated in the strategic plan and the programs and activities funded in the budget. Performance measures provide information on whether goals and objectives are being met.

(10) Obtain Approval of the Plan.

Policymakers should formally approve the strategic plan so it can provide the context for policy decisions and budget decisions.

(11) Implement the Plan.

Organization stakeholders should work together to implement the plan. Moreover, the strategic plan should drive the operating budget, the capital plan, and the government’s other financial planning efforts.

(12) Monitor Progress.

Progress toward planned goals should be monitored at regular intervals. Organizations should develop a systematic review process to evaluate the extent to which strategic goals have been met.

(13) Reassess the Strategic Plan.

Many external factors, such as the national or regional economy, demographic changes, statutory changes, legislation, mandates, and climate/environmental changes, may affect the environment and thus achievement of stated goals. To the extent that external events have long-range impacts, goals, strategies and actions may need to be adjusted to reflect these changes. New information about stakeholder needs or results may also require changes to the plan. It is desirable to minimize the number of adjustments to longer-term goals in order to maintain credibility. However, governments should conduct interim reviews every one to
three years, and more comprehensive strategic planning processes every five to ten years, depending on how quickly conditions change. Performance measure results need to be reviewed more frequently than the strategic plan.

**Long-Term Financial Planning**


**Background:**

Long-term financial planning combines financial forecasting with strategizing. It is a highly collaborative process that considers future scenarios and helps governments navigate challenges. Long-term financial planning works best as part of an overall strategic plan.

Financial forecasting is the process of projecting revenues and expenditures over a long-term period, using assumptions about economic conditions, future spending scenarios, and other salient variables.

Long-term financial planning is the process of aligning financial capacity with long-term service objectives.

Financial planning uses forecasts to provide insight into future financial capacity so that strategies can be developed to achieve long-term sustainability in light of the government's service objectives and financial challenges.

Many governments have a comprehensive long-term financial planning process because it stimulates discussion and engenders a long-range perspective for decision makers. It can be used as a tool to prevent financial challenges; it stimulates long-term and strategic thinking; it can give consensus on long-term financial direction; and it is useful for communications with internal and external stakeholders.

**Recommendation:**

GFOA recommends that all governments regularly engage in long-term financial planning that encompasses the following elements and essential steps.

A long-term financial plan should include these elements.

1. **Time Horizon.** A plan should look at least five to ten years into the future. Governments may elect to extend their planning horizon further if conditions warrant.

2. **Scope.** A plan should consider all appropriated funds, but especially those funds that are used to account for the issues of top concern to elected officials and the community.

3. **Frequency.** Governments should update long-term planning activities as needed in order to provide direction to the budget process, though not every element of the long-range plan must be repeated.

4. **Content.** A plan should include an analysis of the financial environment, revenue and expenditure forecasts, debt position and affordability analysis, strategies for achieving and maintaining financial balance, and plan monitoring mechanisms, such as scorecard of key indicators of financial health.

5. **Visibility.** The public and elected officials should be able to easily learn about the long-term financial prospects of the government and strategies for financial balance. Hence, governments should devise an effective means for communicating this information, through either separate plan documents or by integrating it with existing communication devices.
A long-term financial plan should include these steps.

1. **Mobilization Phase.** The mobilization phase prepares the organization for long-term planning by creating consensus on what the purpose and results of the planning process should be. The mobilization phase includes the following items:
   - **Alignment of Resources.** This step includes determining the composition of the project team, identifying the project sponsor, and formulating a strategy for involving other important stakeholders. This step also involves the creation of a high-level project plan to serve as a roadmap for the process.
   - **Preliminary Analysis.** This step helps raise awareness of special issues among planning participants, such as the board or non-financial executive staff. A scan of the financial environment is common at this point.
   - **Identification of Service Policies and Priorities.** Service policies and priorities have important implications on how resources will be spent and how revenues will be raised. A strategic plan or a priority setting session with elected officials could be useful in identifying service policies and priorities.
   - **Validation and Promulgation of Financial Policies.** Financial policies set baseline standards for financial stewardship and perpetuate structural balance, so a planning process must corroborate policies in place (as well as the organization’s compliance with those policies) and also identify new policies that may be needed.
   - **Definition of Purpose and Scope of Planning.** The purpose and scope of the planning effort will become clear as a result of the foregoing activities, but the process should include a forum for developing and recognizing their explicit purpose and scope.

2. **Analysis Phase.** The analysis phase is designed to produce information that supports planning and strategizing. The analysis phase includes the projections and financial analysis commonly associated with long-term financial planning. The analysis phase involves information gathering, trend projection, and analysis as follows:
   - **Information Gathering.** This is where the government analyzes the environment in order to gain a better understanding of the forces that affect financial stability. Improved understanding of environmental factors should lead to better forecasting and strategizing.
   - **Trend Projection.** After the environment has been analyzed, the planners can project various elements of long-term revenue, expenditure, and debt trends.
   - **Analysis.** The forecasts can then be used to identify potential challenges to fiscal stability (e.g., "imbalances"). These could be fiscal deficits (e.g., expenditures outpacing revenues), environmental challenges (e.g., unfavorable trends in the environment), or policy weaknesses (e.g., weaknesses in the financial policy structure). Scenario analysis can be used to present both optimistic, base, and pessimistic cases.

3. **Decision Phase.** After the analysis phase is completed, the government must decide how to use the information provided. Key to the decision phase is a highly participative process that involves elected officials, staff, and the public. The decision phase also includes a culminating event where the stakeholders can assess the planning process to evaluate whether the purposes for the plan described in the mobilization phase were fulfilled and where a sense of closure and accomplishment can be generated. Finally, the decision phase should address the processes for executing the plan to ensure tangible results are realized.

4. **Execution Phase.** After the plan is officially adopted, strategies must be put into action (e.g., funding required in achieving goals). The execution phase is where the strategies become operational through the budget, financial performance measures, and action plans. Regular
monitoring should be part of this phase. The following diagram highlights the various long-term financial planning phases discussed in this recommended practice.

References:


*Departmental Presentation in the Operating Budget Document*

Source: http://www.gfoa.org/departmental-presentation-operating-budget-document
Background:
The departmental section of a budget document traditionally has focused on accomplishments and detailed financial schedules. Recently, however, emphasis is also being placed more and more on describing programs or services and how their objectives will be met. A well-designed departmental section can enhance a reader’s understanding (assuming the reader is the general public or a decision-maker) of the purpose of funded programs or services, as well as their cost, making the budget document a more effective operational and communications document.

Recommendation:
GFOA recommends that governments consider the following guidelines when presenting information in the departmental section of the operating budget document:

1. Design. The formatting can be enhanced as follows:
   - Use a standard format for all departments (e.g., font size and type, margins, paragraph alignment and spacing, bullet points, indentation, and the consistent use of a single format (i.e., portrait or landscape);
   - Use pictures, graphs, charts, borders, tabs, and dividers to enhance the presentation of information, taking care to place them in the section to which they relate;
   - Include interesting facts or employ a ‘did you know?’ format to attract interest; and
   - Use hyperlinks that allow the reader to obtain additional information not included in the budget document.

2. Brevity. Avoiding excessive detail is important, especially in financial schedules and text:
   - Consider summarizing financial information rather than presenting each account in whole dollars (rounding may be beneficial);
   - Keep discussions focused and concise; and
   - Avoid excessive detail (consider the possibility of a separate supplemental departmental document for those desiring more detail).

3. Services. A description of services or functional responsibilities must be included:
   - Consider including hours of operation, address, phone number, email address, brief departmental historical recap, linking department to fund structure, and contact information (e.g., head of the department);
   - Identify any changes in service levels (increase or reduction). This may include the dollar impact and the potential effect on the public;
   - Discuss whether services are performed in-house or privatized; and
   - Activities required by law always need to be covered.

4. Issues. Discuss challenges, issues, and opportunities:
   - Go beyond a mere listing of functional responsibilities to discuss challenges, issues, and opportunities. The discussion needs to focus on the future and key decision points, with an emphasis on solutions.

5. Revenues. Revenues may include any fees or charges that the department generates:
   - While many departments do not generate revenues, some do. If so, discuss the major type of revenues and the potential recovery rate.
6. Expenditures. The analysis of expenditures should be done in a broad manner:
   - Consider identifying major categories (rather than identifying, discussing, and analyzing every expenditure account) and note any significant changes. For example, major categories may include wages and benefits, supplies, etc. Some governments include budget highlights for each department.

7. Staffing. Staffing information is usually presented in one of two manners:
   - A departmental organization chart may be provided to supplement the main organization chart of the government and
   - A brief schedule may summarize the departmental headcount over a period of time (including the upcoming budget year), which would have the advantage of identifying trends.

8. Prioritization/Goals and Objectives. It has becoming increasingly common to explain how services are prioritized:
   - A brief recap of any citizen surveys that a department has undertaken may be presented and
   - Linking departmental goals and objectives to overall entity goals can be done through the use of a matrix. The use of timeframes and quantifying goals is encouraged.

9. Measures. Performance measures typically are included in the respective departmental section of the budget document:
   - Each department is encouraged to present performance measures that link with the goals of both the overall entity and the department;
   - Performance measures should include input, output, efficiency, and effectiveness measures and their relationship to achieving desired outcomes;
   - Include measures for the prior, current, and upcoming budget year; and
   - A discussion of key measures is becoming increasingly common.

References: