ARIZONA CHAMBER FOUNDATION

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POLICY BRIEF

Schoolhouse Ad Hoc: The State of School Construction in Arizona

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A general obligation (GO) bond is a municipal bond backed by the full faith and credit, or "taxing power," of the issuing jurisdiction. The issuing jurisdiction pledges to raise taxes sufficient to cover periodic interest payments and principal amounts. School districts in Arizona levy secondary property taxes in order to service GO bonds.

A revenue bond is a bond payable from a dedicated revenue stream that is generated from a project, such as fees, rents, and other revenue-generating sources. While school districts were traditionally unable to issue revenue bonds (as their public schools produced no "revenue"), some districts have creatively structured leasing arrangements to use state education funds as the "revenue."

A lease-purchase agreement involves the purchase of an asset through periodic lease payments, which have principal and interest components. Lease-purchase financing is an alternative to purchasing an asset with cash, acquiring its use for a period of time through a true lease, or issuing bonds.

The Problem

Today, Arizona has two types of public K-12 school systems; traditional public school districts and the growing system of public charter schools. The financing mechanisms and available funds to pay debt to build schools differ for these two systems. Districts can access local property taxes that are in addition to classroom funding to build and fix schools, but only with voter approval. This means some districts have capital money while others do not. Charters do not have access to local property taxes and must rely on dollars intended for the classroom to finance new buildings. While charter schools receive slightly more from the state to partially account for lack of access to local property taxes, it is not enough. Bottom line, both systems are unstable, inefficient, and create inequities for students.

The state was ordered to resolve the equity issues related to school construction for districts two decades ago. The approved fix has run out of money and equity issues for charters have yet to be addressed. The lack of statewide solutions to build schools and keep school buildings safe, efficient and well-maintained is not only draining funds from the classroom but is slowing the growth of our best school systems and may lead to broader use of more expensive financing schemes to keep up with capital needs.

Today, however, Arizona has an opportunity to build a system that will not merely bring down the cost of capital for facilities construction and reduce revenues shifted from classrooms to buildings, but also direct a higher percentage of dollars toward the expansion of high-quality district and charter schools.

How does Arizona currently finance the construction of new district and charter schools?

Today, Arizona builds the majority of new district schools through voter-approved general obligation (GO) bonds. However, increasing numbers of districts are financing their new school facilities with alternative mechanisms including revenue bonds and lease-purchase agreements. These mechanisms tend to be costlier and are generally non-voter approved. Charter schools, not able to issue GO bonds, are also using these alternative mechanisms in large part to finance their facilities.

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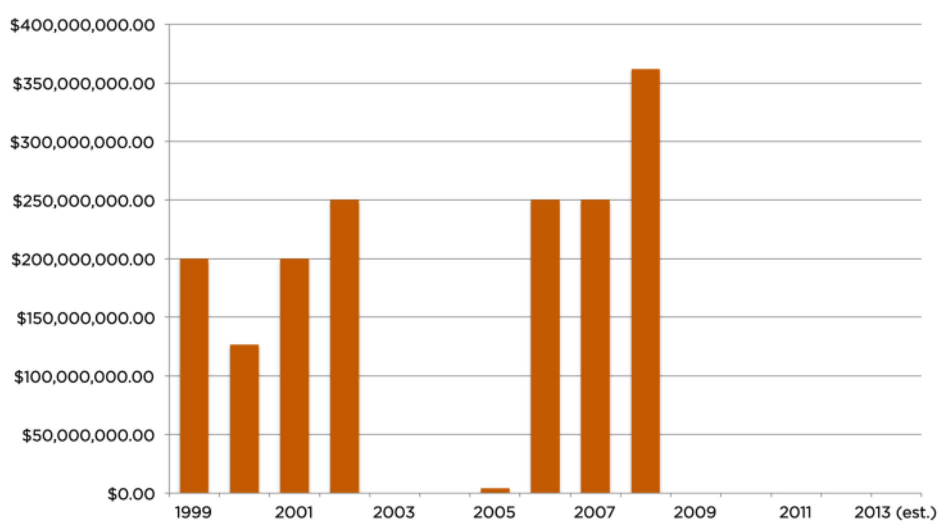
Students First

Until the late 1990s, Arizona financed the construction of new district schools almost exclusively through GO bonds issued by the local district. Because GO bonds are secured by a district's pledge to levy property taxes sufficient to cover the debt service, credit rating agencies generally assign GO bonds relatively strong credit ratings. These high credit ratings allowed many districts to access relatively inexpensive capital in order to finance school construction. However, this financing system created a disparity among Arizona school districts. Property-rich districts with high-value commercial and residential land were able to raise a great deal of money without assessing burdensome property taxes on residents. Counterintuitively, residents in property-poor districts ended up paying a much higher percentage property tax while still ending up with inferior school facilities because of their inability to raise enough through GO bonds.

These inequities led to legal challenges in the 1990s.[1] In a trilogy of Arizona Supreme Court cases ending in 1998, the Court held that financing school facilities mostly through local GO bonds violated the Arizona Constitution's "general and uniform" public education requirement. In the aftermath, legislators passed "Students FIRST" to comply with the Court's holding. The law established and readied the School Facilities Board (SFB) to fund public school construction and repairs statewide for district schools.[2] The goal was to ensure that all district school facilities would be constructed and maintained at an acceptable minimum level, regardless of the local district's property wealth. As part of this arrangement, following an initial investment from sales taxes approved by the voters in 2000, the Legislature agreed to fund the SFB from the state's general fund, rather than local property taxes. The Legislature also capped local districts' ability to issue GO bonds at a limit much lower than previously permitted.[3] However, the SFB relies on discretionary annual appropriations from the Legislature. Predictably, this has led to defunding the SFB over time. In 1999, the SFB funded $485 million in new school construction projects.[4] In 2011, it approved $1.3 million in new facilities, and has not approved a new construction project since (Chart 1).

Chart 1:
School Facilities Board: New School Facilities Funding since 1999 (Only district construction)

Source: Joint Legislative Budget Committee's website, "Fiscal History" tab, Yearly Reports: http://www.azleg.gov/jlbc/fiscal.htm.



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In response to the SFB's chronic underfunding, districts have again turned to GO bonding to finance new construction. In 2013, the Legislature agreed to double local districts' capacity to issue GO bonds in order to allow greater flexibility.[5] Nevertheless, many districts seeking to finance new construction have reached the increased bond capacity or are unable to convince residents to pass new GO bonds. This has led more districts to enter into private arrangements with developers such as lease-purchase agreements, and more recently, to seek alternative bond financing.[6] Today, the vast majority of school district debt still resides in voter-approved GO bonds, but lease-purchase debt is increasing.[7]

In the midst of these changes to traditional district school financing, charter schools emerged in Arizona in 1995. Today, charters educate more than 15 percent of Arizona public school students. As illustrated in Chart 2, that number is quickly growing. In fact, since 2008 charter school enrollment has grown steadily at around 9 percent per year. During that time, district enrollment has fallen by 37,000 students statewide.

Charters receive public funding on a per-pupil basis and are not able to access GO bonds for financing new school construction. However, many charters have been able to use this per-pupil funding to secure revenue bonds through banks and development authorities. Others find new construction to be prohibitively expensive and choose instead to lease space.

The reality today is that charters have taken up a substantial portion of new growth in enrollment for the last six years. This trend shows no signs of slowing, so it is imperative that Arizona seeks to resolve new school financing mechanisms for both charter and district school facilities.

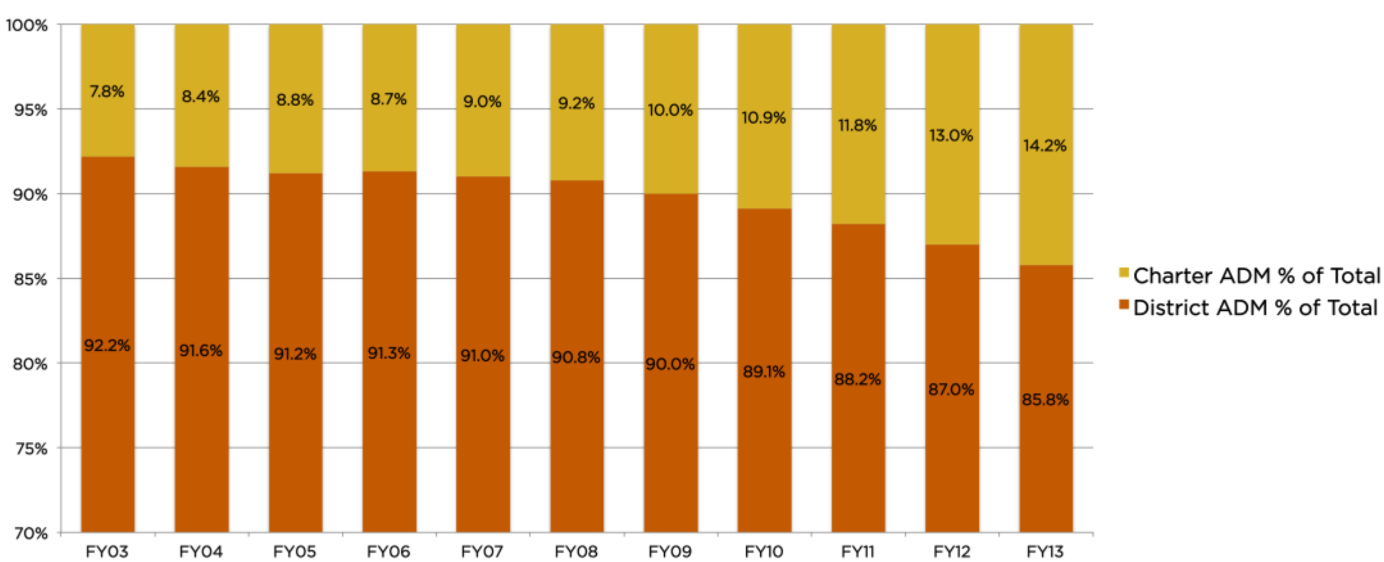
Why does the current system present a problem?

The nearly complete defunding of the SFB has left in its wake an ad hoc system of financing public school construction that is costing Arizona schools money and making it difficult for high-quality schools to expand.

This system has resulted in many districts once again financing new school facilities by issuing GO bonds. This is problematic

Chart 2:
District and Charter school enrollment since 2003
(by Average Daily Membership)

Source: From ADE's LEA information request website 5/30/2013: http://www.ade.az.gov/schoolfinance/forms/LEAQuery/InformationRequest.aspx. ADM counts for online district and charter schools are included in the computation.



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for several reasons. School districts prefer to finance new construction with GO bonds because they often provide the lowest cost of capital for financing new school facilities.[8] This lower cost is obviously desirable—it allows the districts to spend less taxpayer money on servicing debt and more on the core academic mission. However, fast-growing suburbs and property-poor central city districts alike often find themselves unable to issue sufficient GO bonds to finance new facilities. This is a resurgence of the problem that led to court challenges nearly 20 years ago: property-poor districts cannot access financing to build or maintain schools and may go looking for more costly financing, while property-rich districts are able to access much more money through GO bonds and more readily address local capital needs. Some parties argue the issue could be relitigated as the current system has come to violate the Arizona Constitution once again.[9]

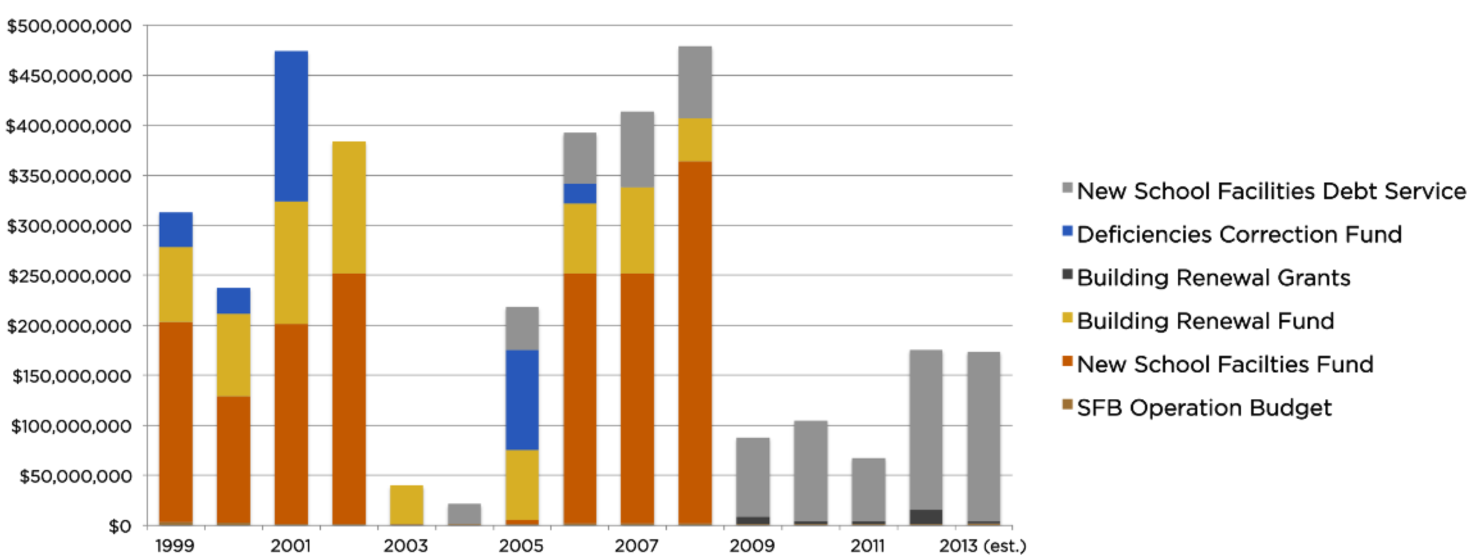
Finally, as noted above, charters are beginning to grow faster than traditional district schools. Because charters cannot access GO bonds at all, this is a materially more expensive and therefore inefficient method of financing Arizona school facilities in the future.

Today's alternatives to GO bond financing are putting financial strains on district and charter school operators. Lease-purchase agreements are almost always costlier than GO bonds. School operators must pay a higher margin to developers for their willingness to build a school up front and accept the risk associated with the operator/tenant paying down the debt from general operating funds rather than through dedicated property taxes. Along with fees, schools usually end up paying much more for lease-purchase agreements than GO bonds. Today's SFB funding goes almost entirely to paying down debt incurred by lease-purchase agreements entered into in lieu of appropriations for new construction (Chart 3).

From the beginning, charters have also relied on revenue bonds. Charters make payments out of the per-pupil funding they receive from the state, money that is otherwise intended for operations. Many of these bonds come through municipal development agencies,[10] but private banks also participate in this market.

Chart 3:
Total State Appropriations to School Facilities Board Since 1999 (by line item)

Source: Joint Legislative Budget Committee's website, "Fiscal History" tab, *Yearly Reports*: http://www.azleg.gov/jlbc/fiscal.htm.



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Revenue bonds like these are riskier than GO bonds, as there is always a risk a school operator will lose students or be shut down.[11] This risk can make revenue bonds significantly costlier. Charters often operate as franchises and combine the financing of multiple school sites in order to decrease risk and secure lower rates. Though many charter schools have proven to be creditworthy borrowers, banks nevertheless view single school operators as riskier than a district that can tax to pay off any indebtedness.[12] Despite these relatively higher financing costs, some traditional district schools desperate for new facilities have now begun using revenue bonds after not being able to secure GO bonding.[13]

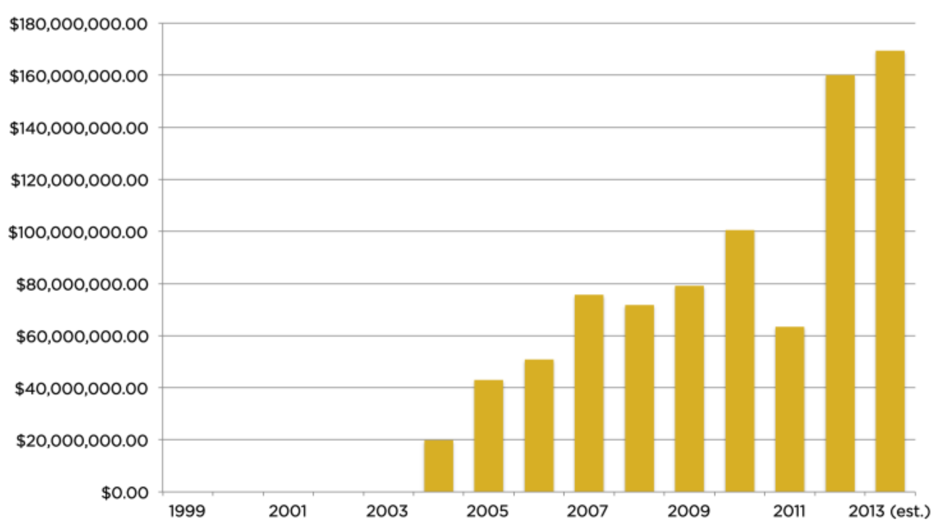
Limited resources, in combination with the trends noted above, are problematic. These factors tend to increase significantly the amount many schools are paying for debt as a percentage of their total operating budget. On average, charter schools are paying 10-20 percent of all revenue toward facilities cost.[14] While a charter school using only 10 percent of its revenues for facilities is in a relatively good position to secure more favorable financing terms, most schools need to stretch to 15-20 percent to secure their minimal facility needs.

Given limited revenue resources and the market's hesitance to provide financing that requires more than 20 percent of a school's resources for facilities, many schools must accept sub-par facilities or cannot access the market at all. These high financing costs take away precious funds from teacher pay, training, and other core educational functions.

Importantly, the current system also makes no strong preference for placing high-quality schools in new facilities. Many high-quality schools would like to expand, but face an insurmountable challenge in financing new school space. In particular, high-quality schools serving primarily low-income students have found it difficult to replicate in this environment. As financing for new school construction becomes scarcer, it becomes more imperative to ensure that quality operators are able to secure adequate facilities when they are ready and willing to replicate. Currently, districts build their new schools almost exclusively to satisfy population growth. But many districts are shrinking, and when quality charter or competing district operators seek to expand, they often find themselves unable to access financing for new facilities or even vacant district school buildings.

Chart 4:
Amount of debt service payments from SFB since 1999

Source: Joint Legislative Budget Committee's website, "Fiscal History" tab, Yearly Reports: http://www.azleg.gov/jlbc/fiscal.htm.



How have other states sought to address the problem?

Others states have used various methods to create cheaper and more reliable sources of funding for new high-quality schools. The existing strategies fall into three general categories: 1) credit enhancements for school borrowers, 2) direct grants or tax credits, and 3) making better use of vacant school facilities.

Credit enhancements for district and charter schools alike have become more common. In Texas, the Permanent School Fund guarantees bonds issued by local school districts for new construction.[15] The state has recently extended the guarantee to charter schools.[16] This guarantee significantly reduces the cost of capital for building new schools. The state created the fund, estimated at over $30 billion, through the sale and lease of state trust lands and mineral resources. On a per capita basis, this would equate to a roughly $7.8 billion amount in Arizona. Colorado uses two complementary programs to lower borrowing costs for charters.[17] The "moral obligation" bond program uses the state's creditworthiness to ensure that school borrowers do not miss payments on construction loans. In the event of default, the governor instructs the legislature to appropriate funds sufficient to cover the payments. The state's "moral obligation" is to make the payments or risk a credit hit. The complementary Charter School Intercept Program allows schools to instruct the state treasurer to make bond payments directly on its behalf, withholding operating funds when necessary.[18] This serves as an additional guarantee to lenders that schools will not miss payments, thus lowering the cost of borrowing even further.

Direct grants or tax credits are being used to subsidize construction costs or attract private investment for new school facilities. Colorado has attempted to directly finance the construction of new quality schools through its Building Excellent Schools Today (BEST) program.[19] BEST awards grants to new district and charter schools that submit winning bids proposing new high-quality schools. The program is funded from state land trust funds, lottery spillover funds, marijuana excise taxes, and interest. The grants allow new schools to gain extremely low cost facilities in order to dedicate much more of their operating budget toward the academic mission.[20] While no state has yet implemented a tax credit scheme to attract private equity in new schools,[21] many states have become very familiar with federal Qualified School Construction Bonds (QSCB).[22] This program allows schools to borrow very cheaply for certain capital improvements, and in exchange lenders are granted federal tax credits.

Finally, some states have attempted to better use existing vacant school facilities in order to avoid the expense of building new. Fifteen states have adopted laws enabling new charters to move into empty district facilities, with California, Georgia, and D.C. experiencing some success. However, the most successful efforts have been at the municipal level. In Denver, around 60 percent of charter schools are located in district facilities.[23] This makes much better use of the public's investment in school facilities, and allows both charters and the district to save money, especially if the district can use the charter's 'rent' to help pay off the bonds from an otherwise empty building.

What options does Arizona have to reduce the facilities barrier for high-quality schools looking to expand?

There are multiple options that Arizona could consider to reduce the cost of capital for high-quality schools. The Arizona Permanent Land Endowment Trust Fund, created by revenues from State Trust Lands, is already managed to provide support for public education in the state. Today, the Trust's permanent fund stands at over $4.5 billion, and the remaining State Trust land itself is worth a great deal more. While smaller than the Texas fund, such a trust could greatly reduce the cost of issuing bonds for quality schools looking to expand.

In order for schools to gain access to the fund (and potentially receive additional grant assistance from the state), Arizona could organize a program similar to BEST in order to ensure that quality schools looking to expand face few barriers up front and few drains on operating budgets once up and running. A competitive vetting process would allow the state to reserve limited resources for high-quality district and charter schools with a proven model that are seeking to rapidly expand. Among other resources, Arizona should follow other cities and states who have found ways to make vacant district school facilities available to new school operators when appropriate.

Arizona could go further in encouraging the construction of new high-quality schools. Today, there is great potential to create a public-private revolving fund to assist quality district and charter school operators looking to expand. Programs like New Schools for Phoenix have already begun experimenting with this idea.[24] The state could create a vehicle to attract private capital, combined with philanthropy and the types of state support mentioned above in order to build a fund that would efficiently finance facilities specifically for high-quality schools in Arizona. Under the current financing system, district and charter schools in low-income areas often find new construction prohibitively expensive. Today, however, a number of high-quality schools serving primarily low-income students are ready and willing to expand. Importantly, these are district and charter schools alike; in recent surveys, a vast majority of high-quality schools confirmed their interest in expanding and frustration with the facilities challenge. Arizona now has the opportunity to overcome these inequities while using taxpayer dollars far more effectively to advance the academic missions of our schools and ensure high-quality education for all students.

ARIZONA'S OPTIONS

1. Use the State Land Trust to back bonds
2. Consider a grant program to access state dollars for school construction
3. Allow high-quality schools to access vacant district schools
4. Develop a partnership to create a revolving loan fund to finance high-quality schools

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[1] Arizona State Facilities Board, *Students First Opinions*, http://www.azsfb.gov/sfb/agency/pages/formDoc.asp?theType=0&section=14&Go=Go.

[2] Arizona State Facilities Board, *SFB Overview*, http://www.azsfb.gov/sfb/agency/pages/generalContentPage.asp?pageID=4.

[3] The Arizona Constitution only allows school districts to sell GO bonds up to 15 percent of the district's secondary (full cash) value for grade school and high school districts, and 30 percent for unified districts. After Students FIRST, the Legislature passed a statute lowering this bond cap to 5 percent and 10 percent for grade/high school districts and unified districts, respectively. Arizona Tax Research Association, *Newsletter*, Vol. 74 No. 3 (Apr. 2014), http://www.arizonatax.org/sites/default/files/publications/newsletters/file/atra_apr_2014_newsletter.pdf.

[4] Arizona State Facilities Board, *General Information*, "New Construction Approvals to Date," http://www.azsfb.gov/sfb/agency/pages/formDoc.asp?theType=0&section=15&Go=Go.

[5] In 2013, the bond cap was raised to 10 percent and 20 percent of secondary value for grade/high school districts and unified districts, respectively. Arizona Tax Research Association, *Newsletter*, Vol. 74 No. 3 (Apr. 2014), http://www.arizonatax.org/sites/default/files/publications/newsletters/file/atra_apr_2014_newsletter.pdf.

[6] In 2012 Higley Unified School District, unable to issue more GO bonds, secured $69 million in revenue bond financing from the Phoenix IDA to finance two new schools. The District and IDA structured the deal such that the funds were actually received by a non-profit, as required by the IDA. Non-traditional structures are required for district schools to secure funds from revenue bonds. Phoenix IDA, *Our Successess*, http://phoenixida.com/our-successes/.

[7] Arizona Tax Research Association, *Newsletter*, Vol. 74 No. 3 (Apr. 2014), http://www.arizonatax.org/sites/default/files/publications/newsletters/file/atra_apr_2014_newsletter.pdf.

[8] Legislative Analyst's Office, *Frequently Asked Questions About Bond Financing*, http://www.lao.ca.gov/2007/bond_financing/bond_financing_020507.aspx.

[9] Bob Ortega, "Arizona School Funding Formula Debated," *Arizona Republic*, http://www.azcentral.com/news/articles/arizona-schools-funding-debated.html.

[10] Arizona allows charters to access both tax-exempt and taxable bond financing through city and county development agencies. The development agencies are simply conduit bonding agencies and do not provide credit enhancement for the charter bonds. As such, interest on these bonds may be fairly expensive for charter operators.

[11] This risk is obviously increased when the state does not take measures to ensure that "A quality" operators are placed into new school facilities.

[12] Charter schools though have proven to be good credit risks over time. A 2011 study showed that out of $1.2 billion in loans to charters analyzed, only 1% ended in foreclosure, with only 0.2% eventually written off. "A Decade of Results: Charter School Loan & Operating Performance," Quantitative Economics and Statistics Practice, Ernst & Young LLP (2011), available at http://www.liifund.org/wp-content/uploads/2011/05/Decade-of-Results-CS-Loan-Operating-Performance-05-11.pdf. Despite this, individual school failures can still affect risk perceptions. Moody's recently downgraded the credit rating of an Arizona Charter bond series after the announcement that the largest school in the charter bond pool was going to be shut down by the state. "Moody's downgrades I.D.A. of Maricopa County's (AZ) Education Revenue Bonds; $15 million of debt affected," Moody's, https://www.moodys.com/research/Moodys-downgrades-IDA-of-Maricopa-Countys-AZ-Education-Revenue-Bonds--PR_299082.

[13] See the Higley Unified example, footnote 9.

[14] "Funding Strategies for Charter School Facilities," National Conference of State Legislatures, Webinar (Dec. 2013), http://www.ncsl.org/documents/educ/CharterFacilitiesFundingWebinar.pdf.

[15] Texas Education Agency, *Texas Permanent School Fund*, http://www.tea.state.tx.us/index4.aspx?id=2147485578&menu_id=2147483695.

[16] The PSF was formally opened to Texas charters in April 2014. Since that time, a private bank has underwritten the first two guaranteed bonds (totalling approximately $150 million) for Life Schools of Dallas and KIPP Houston. Rates on those bonds were under 4% for long-term bonds. Comparable unenhanced charter bonds would have rates approximately 1.5% higher.

[17] "Charter School Intercept and Moral Obligation," Colorado Department of Treasury, http://www.colorado.gov/cs/Satellite/Treasury_v2/CBON/1251590262898 (last visited July 3, 2014).

[18] Id.

[19] Colorado Department of Education, *Building Excellent Schools Today (BEST)*, http://www.cde.state.co.us/sites/default/files/CCABESTFactSheet_6.pdf.

[20]Utah also has a state guarantee program for charters that provides a moral obligation of the State to back up the credit of qualifying charter schools. Like Colorado, this allows the bonds to be sold with a higher credit rating and to secure materially lower interest rates. http://le.utah.gov/~2012/bills/static/SB0152.html.

[21] Schemes using tax credits to attract private investment are common in other areas, most notably in low-income housing construction. Low Income Housing Tax Credits allow investors to receive federal income tax credits, which lowers their need to receive returns from the property itself. The presence of this private equity tends to lower the cost of the debt used to finance the rest of the project. "Low Income Housing Tax Credit (LIHTC) Program," Arizona Department of Housing, http://www.azhousing.gov/ShowPage.aspx?ID=83 (last visited July 2, 2014).

[22] http://www.irs.gov/pub/irs-tege/tc_and_stcb_q-a._09-07-10_1.5.pdf.

[23] "Accessing Available District Space," National Alliance for Charter Schools, http://www.publiccharters.org/wp-content/uploads/2014/01/NCSC-Access-to-Availabe-SD-Facilities.-Final.-6-13-11_20110718T151917.pdf.

[24] New Schools for Phoenix, *What We Do*, http://newschoolsforphoenix.org/what-we-do/.