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**SCHOOL CAPITAL EXPENDITURE FINANCE
IN MICHIGAN
ISSUES AND ALTERNATIVES**

by

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INTRODUCTION

In Michigan, the capital expenditures for local school district facilities are the responsibility of each local district. With voter approval, local districts can issue bonds to raise funds for school construction, renovation, technology upgrades, playgrounds, and other capital projects. The bonds are repaid over time from property tax revenue raised by the levy of debt retirement millage.

Typically, local districts apply to the Department of Treasury for qualification of the proposed bonds. This gives a local district access to the School Bond Qualification and Loan Program, which provides credit protections and the option for the district to receive loans from the State to assist in paying the debt service. Alternatively, a local district can issue nonqualified general obligation bonds, which are issued at the credit rating of the local district.

The School Bond Qualification and Loan Program is operated by the Department of Treasury based on the requirements of Article IX, Section 16 of the Michigan Constitution of 1963 and implementing statutes. Under current law, a school district that obtains qualification of its construction or refunding bonds can issue bonds using State credit enhancements. The Constitution provides for two types of loans to school districts under the program: loans to prevent the default of qualified bonds and loans to allow local districts to maintain a lower and more stable debt millage rate than would otherwise be possible. For the second type of loans, the Constitution permits a district to borrow from the State to meet the debt service on qualified bonds. The loan amount is equal to the revenue in excess of 13 mills (or a lower rate established by the Legislature, currently seven mills) that the district would otherwise have to raise by levying higher debt service millage. This program currently lends districts the amount needed to replace millage revenue that would be raised by a district levy of the mills between seven and 13. This effectively transfers a portion of current debt service costs from the districts to the State. Although the State eventually will be repaid with interest, the State bears significant current and future costs. Local taxpayers have lower millage rates than would otherwise be possible; however, their debt millage is levied for a longer time and the loans increase the interest cost paid for a given project.

Legislative interest has turned to this program due to the rapidly increasing State cost of offering qualified loans to school districts. These costs, which are paid from the State School Aid Fund, have been budgeted at \$93.6 million in fiscal year (FY) 2011-12 and \$120.4 million in FY 2012-13. The Department of Treasury projects that the debt service charged to the School Aid Fund will increase steadily over the next two decades, exceeding \$200.0 million in FY 2021-22. In addition to the direct costs to the State, the local districts incur future costs by participating in the program, which can obligate a district for decades for debt to the State.

Amendments in 2005 reformed the program and created the School Loan Revolving Fund (SLRF) in an effort to reduce State costs; however, due to the unprecedented drop in taxable values, the SLRF did not function as intended and State costs have continued to increase. Using the School Aid Fund to pay the debt service costs of the program reduces the funds available for other purposes such as supporting the school districts' per-pupil foundation allowance, various categorical programs, or, in recent years, higher education and community colleges.

Legislation has been proposed to change the operation of the School Loan Revolving Fund program in order to limit future State costs. As passed by the Senate, the amendments proposed by Senate Bills (S.B.s) 770, 771, and 772 (which are tie-barred) and S.B. 870 would reduce local school district access to State loans and reduce future costs to the School Aid Fund. If the amount of State qualified loans exceeded \$1.8 billion, a district would be prohibited

from obtaining State qualification of bonds for any issue expected to use qualified loans from the State. This would close the qualified loan portion of the program to new entrants as soon as 2014. In addition, a district would be required to wait five years after repaying qualified loans before taking out any additional qualified loans, and local districts would be required to recompute debt millage annually and levy the recomputed millage to ensure that qualified loans would be repaid by the final mandatory repayment date.

Testimony and discussion on these bills have raised questions regarding options to limit the costs of the current program, the amount of funding, if any, that the State should allocate to support school capital expenditures, and potential alternatives for distributing that State support. If Michigan continues to support local district capital spending, the amount appropriated could be distributed to meet a particular policy goal, such as reducing the unmet capital need in the State or closing the disparity in fiscal capacity and facility funding between districts with the highest and lowest taxable values per pupil. The Legislature would be able to modify the operation of the current program within constitutional limits, create a program that operated in addition to the qualified loan program, or completely replace it; however, elimination of the current program would require a constitutional amendment.

This paper reviews the history, current operation, and cost of the School Bond Qualification and Loan Program. It also discusses potential alternative models for State support of local school district¹ capital expenditures and summarizes the programs in Ohio, Massachusetts, and Indiana.

HISTORY

The School Bond Qualification and Loan Program has endured in Michigan since its creation in 1955 by constitutional amendment. The program at that time assisted local school districts with construction of school buildings to accommodate the growth in student population from the young baby boomers. The basic purpose of the program, to provide State loans to school districts to help them in making debt service payments, has remained the same over the 57 years of program operation. The program has been modified, however, by both constitutional amendment and revisions to the implementing statute.

As originally created, the program was more restrictive than in its current form. At that time, the Constitution capped total outstanding qualified loans at \$100.0 million and set the minimum millage that a local district must levy to receive a qualified loan at 13 mills. The program was amended by the voters in 1960, only five years after its inception, to remove the \$100.0 million cap on the amount of State loans.

The Michigan Constitution of 1963 established the parameters for the program that remain in effect. Article IX, Section 16 provides that districts that issue qualified bonds can borrow from the State the amount necessary to pay debt service on qualified debt that exceeds the local revenue from a 13-mill levy or a lower millage determined by the Legislature. Thus, authority for the program is divided between the specific requirements of the Constitution and the authority delegated to the Legislature. The Appendix contains the text of this section of the Constitution.

Public Act 108 of 1961 was enacted to implement the earlier constitutional provisions, and became known as the School Bond Loan Fund (SBLF) Act. The Legislature frequently

¹ This paper is limited to discussion of construction of facilities by local school districts. Except for discussion of the Indiana program, it does not address the capital needs of public school academies or other types of school district borrowing such as school aid anticipation bonds or operating deficit bonds.

amended the statute, in some cases expanding the size of the program and, in others, making changes to target the benefits of the program based on district need or to reduce the State's total loan exposure. Major changes to the program since 1965 are listed below.

- Lowered Minimum Millage. Public Act (P.A.) 169 of 1965 expanded the program significantly by requiring districts to levy seven mills to be eligible to receive qualified loans, as opposed to the original 13-mill requirement.
- Limited Loans Based on Taxable Value Per Pupil. Dramatic changes made by P.A. 9 of 1967 tied access to qualified loans to district tax capacity and tax effort. Tax capacity was measured by State equalized valuation (SEV) per pupil and local tax effort was measured by the school operating millage rate. Districts that levied at least 18 mills for school operating purposes and had the lowest SEV per pupil (under \$5,000 per pupil) received the highest level of State loan participation. Those districts were authorized to borrow 100% of the revenue needed between seven and 13 mills. The percentage of borrowing allowed declined from 100% of the revenue between seven and 13 mills to 20.0% of that amount for districts with SEV per pupil between \$17,000 and \$18,000, also levying 18 mills for school operating purposes. The borrowing percentage was reduced further for districts with a lower school operating millage. Although program details were amended, the basic structure remained in effect until 1971.
- Limited Loans for All Districts. Public Act 35 of 1971 removed the schedule that tied loan limits to taxable values and instituted a uniform borrowing limit of 90.0% of the levy needed to pay principal and interest in excess of the revenue received between seven and 13 mills. Since 1991, districts have been able to borrow up to 100% of that amount.
- Time Limit on Repayment. Public Act 65 of 1991 added a requirement that qualified loans be repaid within 60 months of the retirement of the related qualified bonds. It also introduced the requirement to calculate and levy computed millage required to repay the loans by the repayment date. This was increased to 72 months by P.A. 92 of 2005.
- Increased Oversight. Public Act 290 of 2000 added requirements for specific ballot language regarding qualified loans and repayments and expanded audit requirements.
- School Loan Revolving Fund. A package of bills approved in 2005 repealed the 1961 authorizing legislation and enacted the School Bond Qualification, Approval, and Loan Act. Public Act 92 of 2005 and related legislation² made changes intended to limit State costs of the program. The School Loan Revolving Fund was created in the Shared Credit Rating Act (MCL 141.1066c) to receive repayments and other contributions, which were to be used for new loans under the program. A State revenue bond was issued to provide cash for qualified loans. Repayments under the program were lower than anticipated, primarily due to the decline in taxable values. Currently, new qualified loans are considered to be from the School Loan Revolving Fund; however, State general obligation debt is still needed to provide money to lend. The School Loan Revolving Fund has not reduced State costs as intended.

² Senate Fiscal Agency, "School Bond Loan Fund Reform, S.B. 406, 410, & 411: Enrolled Summary" (January 23, 2007), available at <http://legislature.mi.gov/doc.aspx?2005-SB-0406>

PROGRAM OPERATION

Local districts that want access to the SLRF program start the process by applying to the Department of Treasury to issue qualified bonds. Statute provides for a two-stage process for qualifying a local school district bond issue. Districts may seek prequalification of the bond issue by submitting to the Department of Treasury a detailed application that includes the proposed ballot language, a description of the project, and a number of financial and space utilization measures. The Department is required to *prequalify* bonds if the State Treasurer determines that the district will still be able to repay its existing qualified loans within 72 months after the related bonds are repaid and that the form of the ballot meets the requirements of the School Bond Qualification, Approval, and Loan Act. The State Treasurer is required to *qualify* a bond issue if it has been approved by the voters and the local district is in compliance with the Revised School Code and the Revised Municipal Finance Act, and meets the other criteria outlined in Table 1, which summarizes the steps in the process of issuing qualified school bonds.

Table 1

Summary of the School Bond Qualification and Loan Process	
1.	Local district applies to Treasury for prequalification of bonds.
2.	Treasury determines if the bonds are prequalified based on detailed statutory requirements regarding ballot language, project specifics and costs, and financial projections. These factors are listed in MCL 388.1925.
3.	Local vote. Approval by local voters is required to proceed.
4.	Treasury qualifies the bonds based on updated information that includes approval by local voters, compliance with bonding requirements in the Revised School Code and the Revised Municipal Finance Act, an updated application, and payment of fees.
5.	At qualification, Treasury sets the computed millage for the qualified bond issue, which is at least seven mills for a district taking out qualified loans.
6.	Local district issues bonds.
7.	Local district levies not less than the computed millage to pay debt service.
8.	Local district has the option to request to borrow from the State the "difference" between the revenue from the computed millage (but not less than seven mills) and the actual debt service payments.
9.	State makes qualified loans using either repayments from other districts or, more likely, the proceeds of State-issued general obligation bonds. The State Administrative Board approves the issuance of the State general obligation bonds.
10.	State pays principal and interest on the State's general obligation debt until the debt is retired. The State debt service costs are appropriated from the School Aid Fund and may be reduced by use of repayments from districts at the discretion of the State Administrative Board.
11.	Local district begins to repay the State when the computed millage raises revenue in excess of the debt service due on the qualified bonds.

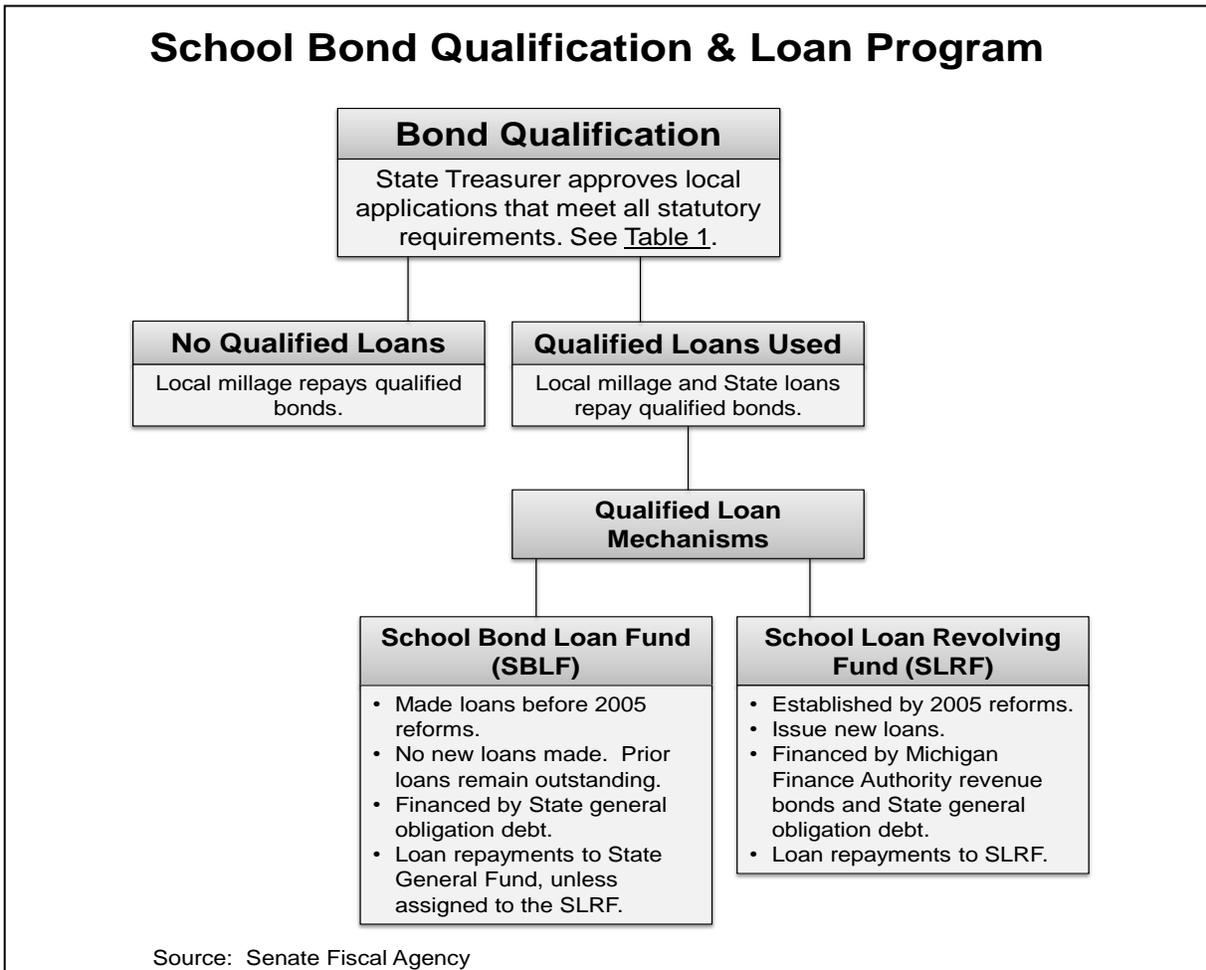
Source: School Bond Qualification, Approval, and Loan Act, P.A. 92 of 2005, and Michigan Department of Treasury, "State of Michigan Bond Qualification Process Overview".

As of 2011, about two-thirds of districts with qualified bonds outstanding had not sought qualified loans. They are required to levy the computed millage which is determined each year, if necessary, to raise sufficient revenue to repay the qualified bonds. The computed millage may be less than seven mills for these districts that are neither borrowing nor repaying qualified loans.

About one-third of districts with qualified bonds use the SLRF program to receive State qualified loans to assist in paying their debt service on the qualified bonds. In order to receive State

qualified loans, a district must levy at least seven mills, the statutory minimum. A district that levies at least seven mills can borrow from the State the difference between the local revenue on seven mills (or the district's computed millage rate established at issuance by the Department of Treasury, whichever is higher) and the debt service payment due on the bond. School districts are required to repay the qualified loans with interest not later than 72 months after the related bond issue is repaid. Figure 1 is a flow chart of the School Bond Qualification and Loan Program.

Figure 1



An example is a district with a current taxable value of \$110.0 million that has issued \$15.0 million in qualified bonds for school construction. Assuming simple level payments on bonds issued at 3.5% interest, the principal and interest due on the qualified bonds will be \$815,600 annually for 30 years. Revenue from seven mills initially will be \$770,000, leaving a gap of \$45,600 to make the first debt service payment. Under the qualified loan program, the district is authorized to borrow the \$45,600 from the State. In later years, assuming that the taxable value of the school district increases, the revenue from the seven mills is expected to be higher, generating sufficient revenue to repay both the bonds and the qualified loans.

Repayment of the loans can take many years depending on the local school district's situation and choices. In the simplest case, the district does not issue additional qualified debt during the term of the repayment and the qualified loans are repaid by the final repayment date of six years (72 months) after the qualified bonds are repaid.

In some cases, however, the district may issue a subsequent qualified bond. In the most common situation, a bond is issued for an additional capital expenditure. The district then has two qualified bond issues outstanding, with greater debt service payments than before and a greater need to borrow from the State. This is one of the "rollover" scenarios that increase the demand for qualified loans. For a district already levying the seven-mill minimum necessary to participate in the program, it is likely that no millage increase will be necessary. While the local taxpayers will not necessarily see an increase in their millage, the duration of the millage is extended considerably. The district continues to levy seven mills, but its need for qualified loans increases by the amount of the debt service on the new bond. The local school district debt increases due to the new bond issue and the additional qualified loans needed to pay the increased debt service. As taxable values increase and the original bond is retired, the need for qualified loans will decline and then repayments to the State will begin.

A second "rollover" scenario occurs when a district issues a refunding bond to repay its qualified loans. This may be coupled with a new bond issue for capital improvements. The proceeds of any refunding bond will be used to repay the qualified loans from the State. While the State is repaid for the original loan, the local district may resume borrowing from the State for debt service on the refunding bonds and the new money issue. Similar to the situation above, the millage rate will likely remain at or near seven mills but the duration of the levy will be extended and local school district debt will increase. The repayment of the qualified loans allows the district to have a new repayment date for loans related to the new bond issues.

PROGRAM UTILIZATION

The majority of Michigan's school districts participate in the School Bond Qualification and Loan Program to take advantage of the constitutional guarantee that the State will lend the districts any funds necessary to prevent default on qualified bonds. The Department of Treasury reports that in 2011, of the 549 local school districts, 426 or 77.6% of all districts had qualified bonds outstanding. Of those districts, 137 local districts either had received qualified loans from the State or expected to borrow. This represents 32.2% of districts with qualified bonds (25.0% of all districts). Over two-thirds of districts with qualified bonds are not borrowing or expecting to borrow from the State under the SLRF program. This information is summarized in Table 2.

Table 2

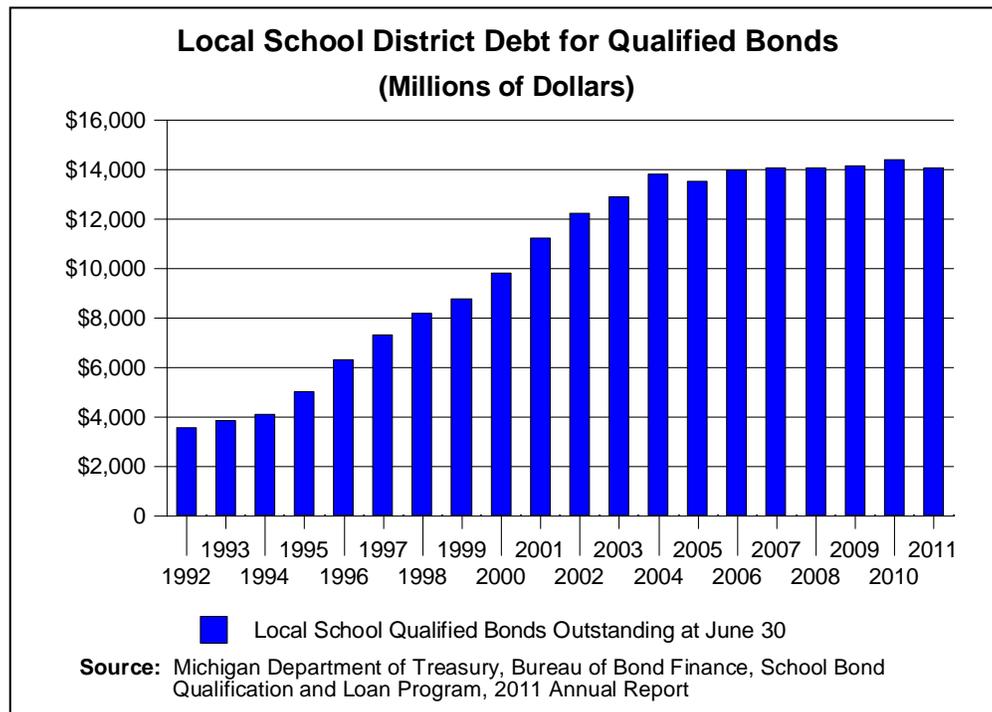
Local District Participation with Qualified School Bonds and Loans - 2011			
Type of District Participation	No. of Local Districts	% Districts with Qualified Bonds	% All Local Districts
Qualified Bonds <i>and</i> Qualified Loans Outstanding or Expected	137	32.2%	25.0%
Qualified Bonds/No Qualified Loans	289	67.8%	52.6%
Subtotal: Districts with Outstanding Qualified Bonds	426	100.0%	77.6%
Districts without Qualified Bonds	123	N/A	22.4%
Total Local School Districts	549	N/A	100.0%

Source: Michigan Department of Treasury, Bureau of Bond Finance, School Bond Qualification and Loan Program Annual Report 2011

The amount of qualified bonds outstanding has increased in almost every year since 1992. In percentage terms, the highest increases were in the years following implementation of Proposal A. Approved by the voters in 1994, Proposal A restructured school finance in Michigan and

limited school operating millage. Beginning in 1995, seven of the next eight years showed increases of over 10.0% in the amount of qualified debt outstanding. The amount of qualified bond debt outstanding has exceeded \$14.0 billion since 2008; however, in recent years increases in qualified bond debt have been modest, followed by a decline in 2011. The amount of qualified bonds outstanding as of December 31, 2011, was slightly over \$14.0 billion. Figure 2 shows the amount of qualified bonds outstanding since 1992.

Figure 2



The amount of qualified loans outstanding shows a markedly different pattern as illustrated in Figure 3. In contrast to the slowing in the growth of qualified bonds, the amount of qualified loans outstanding has increased more quickly in recent years³. This primarily reflects the recent declines in taxable values.

The Department of Treasury projects that under current law, the amount of State qualified loans to local school districts will continue to increase with estimates made through 2034. However, as would be expected, such a long-term forecast relies on several assumptions. Specifically, taxable values were assumed to change over the next five years at the same rate as the average over the last five years; for many districts, this would assume declining taxable value over the next five years. Thereafter, taxable values were assumed to increase by 3.0% annually for each district. The Department assumed new borrowing each year by new entrants starting at \$200.0 million for the first five years, then declining. Figure 4 indicates that local school district qualified loan debt and related State costs (which are discussed further below), will continue to increase for many years, placing additional demands on the State budget.

³ In 1992, all qualified loans were refinanced in a special series of measures that resulted in savings to the State and local school districts. As a result, the amount of qualified loans outstanding was \$0 in that year. A subsequent partial refunding at the end of FY 2002-03 reduced the balance of qualified loans outstanding by \$176.0 million.

Figure 3

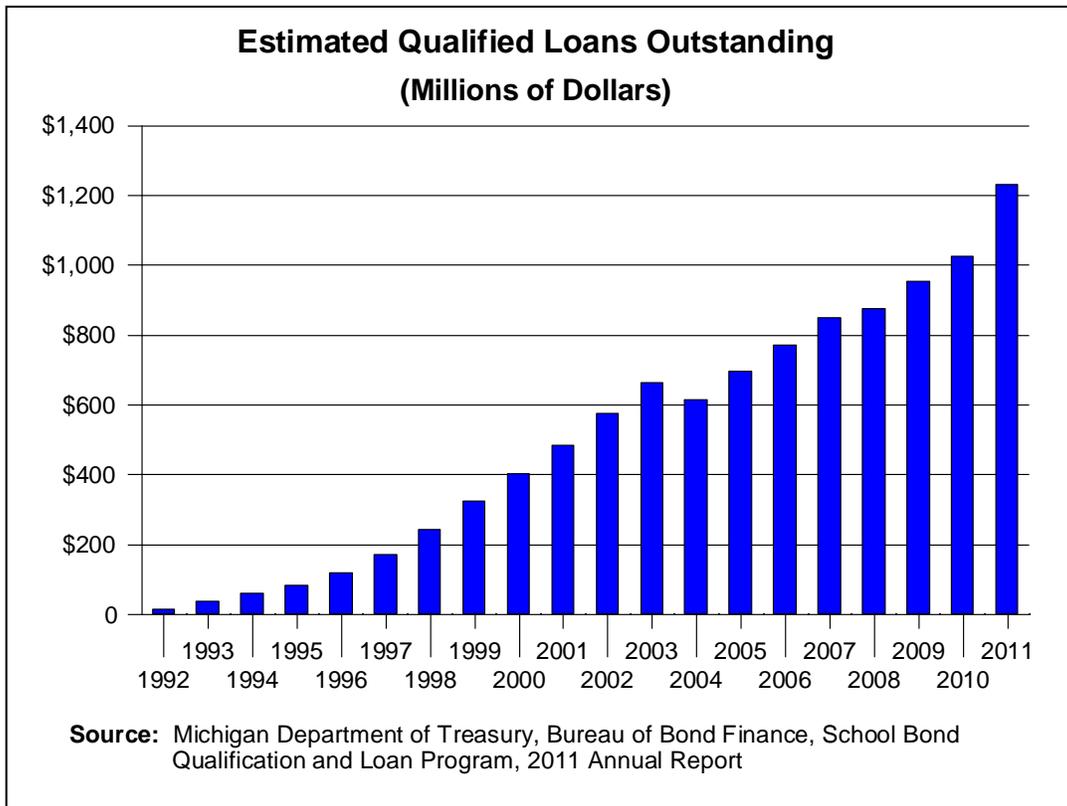
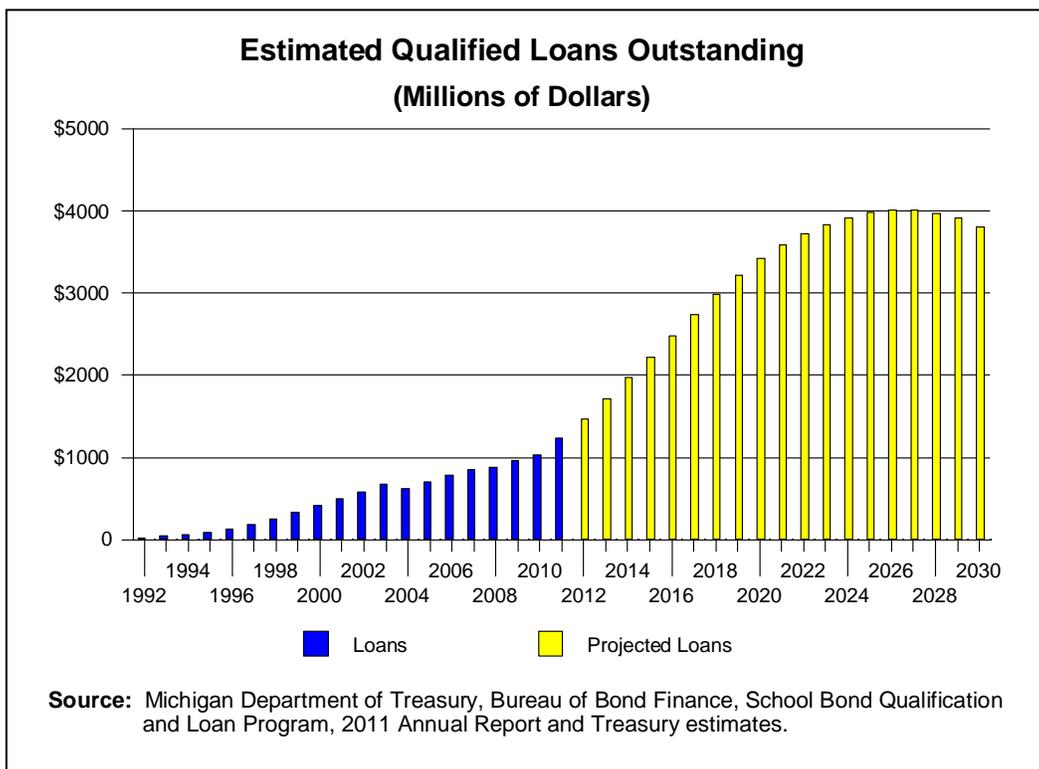


Figure 4



The projected demand for qualified loans in the future is sensitive to the assumptions made regarding changes in taxable values and local decisions regarding capital expenditures. This can be illustrated by returning to the hypothetical school district considered previously. [Table 3](#) summarizes the projected amount of loans needed under various taxable value assumptions in two bonding scenarios.

Table 3

Projected Use of Qualified Loans by a Hypothetical School District under Alternative Assumptions for Bond Issuance and Taxable Value		
	Qualified Bonds Issued	
Initial Bond	\$15,000,000	\$15,000,000
Second Bond (issued year six)	None	\$5,000,000
	Estimated Use of Qualified Loans/ Years with Loans Outstanding	
Taxable Value Assumptions		
2013 - 2016: -2.0% annually	\$809,300 / 18 years	\$6,030,400 / 33 years
2017 - Future: +3.0% annually		
2013 - 2016: 0.0% annually	\$314,200 / 12 years	\$3,550,900 / 31 years
2017 - Future: +3.0% annually		
2013: +1.2%	\$119,200 / seven years	\$1,694,600 / 24 years
2014 - 2016: +2.2% annually		
2017 - Future: +3.0% annually		
Note: Assumes a 3.5% interest rate on 30-year qualified bonds and a 3.25% interest rate on qualified loans.		

The table shows that the projected demand for qualified loans depends on local decisions on how much to borrow. The addition of a second qualified bond greatly increases the total amount of projected qualified loans. The taxable value assumptions have a similar impact in that the projected use of qualified loans is highly sensitive to the assumed rate of growth in taxable values. If taxable values continue to decline, the demand for loans will be much greater than if the taxable values stabilize sooner. Statewide, the May 2012 Consensus Revenue Estimating Conference estimated that revenue from the six-mill State Education Tax will increase by 1.2% in FY 2012-13 and 2.2% in FY 2013-14. The statewide projected taxable value increase, however, may not apply to individual districts that borrow heavily from the SLRF.

STATE COSTS

The State incurs significant current costs to operate the SLRF program. These have been increasing in recent years and are projected to continue to increase. The State costs result from the cost of the funds the State raises to lend to school districts. These are obtained through the issuance of State general obligation bonds authorized by the Constitution. The total amount of State general obligation bonds outstanding for the program was \$865.7 million as of December 31, 2011.

The debt service on these bonds is appropriated in the State budget. Since FY 2002-03, the debt service has been appropriated from the School Aid Fund in the School Aid budget. In prior years, the debt service was appropriated from the General Fund in the budget for the Department of Treasury within the General Government budget. For FY 2012-13, \$120.4 million is appropriated in the School Aid budget (P.A. 201 of 2012) for debt service. The history of year-to-date appropriations for this purpose is shown in [Table 4](#). Section 902 of the boilerplate for the Department of Treasury (P.A. 200 of 2012, Article VIII) provides additional security for bond repayment and program operation by stating that the amount necessary to pay the interest, principal, and costs of issuance for this program is appropriated.

Table 4

Debt Service Appropriations for the School Bond Loan Fund History of Year-to-Date Appropriations FY 1996-97 to FY 2012-13 (\$ in millions)		
	GF/GP	School Aid Fund
FY 1996-97	\$14.8	\$0
FY 1997-98	14.6	0
FY 1998-99	22.9	0
FY 1999-2000	22.9	0
FY 2000-01	27.7	0
FY 2001-02	35.6	0
FY 2002-03	0	4.7
FY 2003-04	0	28.3
FY 2004-05	0	41.1
FY 2005-06	0	44.5
FY 2006-07	0	42.5
FY 2007-08 ^{a)}	0	3.9
FY 2008-09	0	40.0
FY 2009-10	0	40.0
FY 2010-11 ^{a)}	0	5.2
FY 2011-12	0	93.6
FY 2012-13	0	120.4

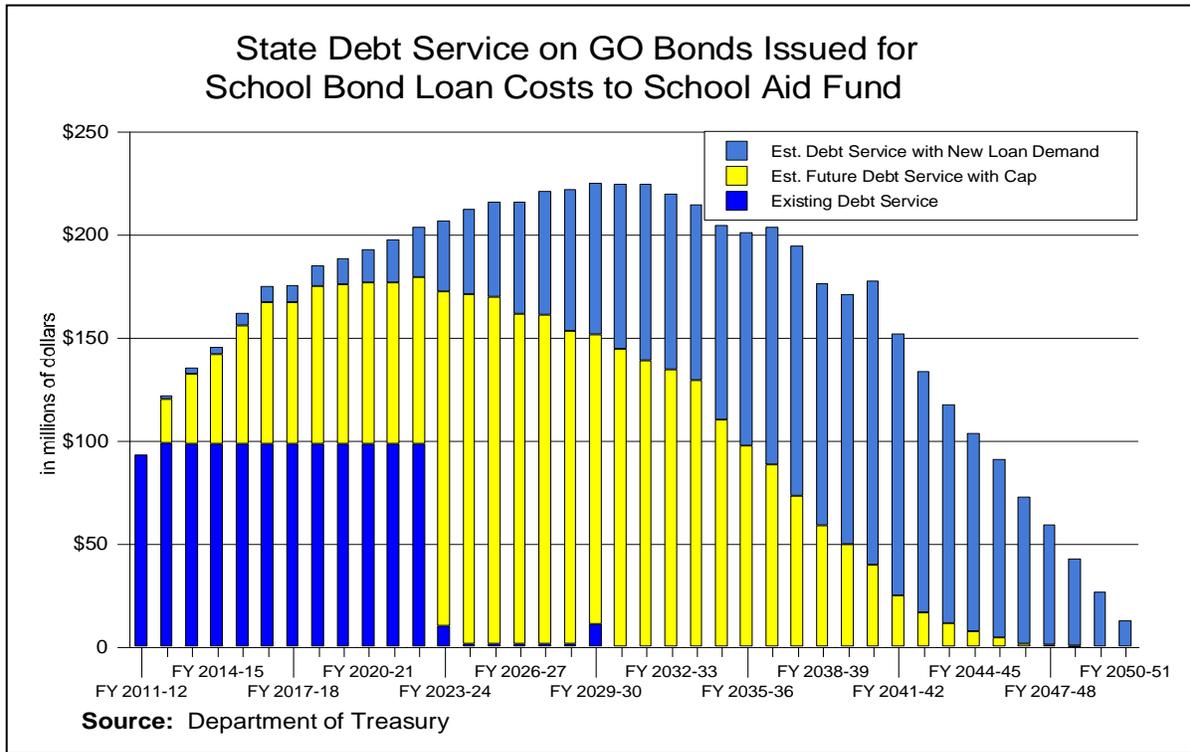
^{a)} Reflects restructuring of State debt.

Source: Appropriation bills

Over time, local school districts repay all of the qualified loans with interest; however, the recent declines in taxable value have increased the volume of qualified loans and reduced the projected annual repayments from school districts. Based on these circumstances, the Department of Treasury is projecting higher State costs in the future, as shown in [Figure 5](#). This chart summarizes the known and projected future costs to the State of qualified loans. The darkest bar on the bottom of the chart represents the State's debt service on existing general obligation bonds already issued to provide funds for the loans. This is the known portion of the State costs. The pale grey bar in the middle represents estimated State debt service on general obligation bonds issued to provide funds to meet the projected loan demand related to qualified bonds that have already been approved and issued. These qualified bonds are eligible to access qualified loans from the State. The amount of loans needed will depend on local taxable values. The estimated State cost, shown here in the pale grey bar, will depend on the amount of loans needed and the market conditions faced by the State at that time. The top bar is projected debt service for State loans related to qualified bonds that have not yet been approved or issued, in the absence of any legislation changing the program. This assumes new issues through the mid-2030s.

The Department of Treasury projects that the duration of the qualified loans will extend far into the future. The Department estimates that 39 districts will not be able to repay their loans within 72 months of the bond repayment as required by statute. For a few of these districts, repayment of all qualified loans is projected to be delayed by decades. With this lengthy delay in repayment, the interest costs to local school taxpayers increase as do the duration and amount of the State's debt service cost on general obligation debt.

Figure 5



The repayments that the State receives from school districts on loans from the SLRF are deposited into the School Loan Revolving Fund. Pursuant to statute, this revenue can be used to make new loans to districts or pay debt service on the State's debt as determined by the State Administrative Board based on recommendations from the Department of Treasury.⁴ Repayments from loans made under the prior SBLF program are deposited into the General Fund, or, pursuant to boilerplate Section 902(3) of the Department of Treasury budget, all repayments that are not required to go into the SLRF are appropriated and may be used by the State Treasurer for the payment of debt service or redemption of bonds. Public Act 112 of 1961 authorizes the State Treasurer to assign repayments of SBLF loans to the SLRF.

In addition to the debt service costs, the Department of Treasury incurs administrative costs for the program, which is administered by the Bureau of Bond Finance. The appropriated operating costs of the School Bond Qualification and Loan program are \$791,300 in FY 2012-13. There are approximately 4.0 full-time equated (FTE) positions allocated to this program. These administrative costs are appropriated in the Treasury line item for Common Cash and Debt Management and are funded by fees paid by participating local school districts. The budget for the Department of Treasury is included within the General Government budget in P.A. 200 of 2012, Article VIII.

POLICY CONSIDERATIONS OF THE CURRENT PROGRAM

The State's current system of capital outlay for local school districts provides substantial local control over the timing and size of local capital projects. Local districts with voter approval determine the facility needs of the school district, within State utilization and cost guidelines. When a district approves a bond issue (after receiving prequalification), then the district can

⁴ An exception to this is repayments of loans financed by revenue bonds from the SLRF. Those repayments go to repay the revenue bonds.

apply for and issue qualified bonds at the State credit rating, which for most districts lowers interest rate costs.

Taking out qualified loans to pay a portion of the debt service on qualified bonds allows a district to levy a lower millage than otherwise would be possible. This strategy increases the cumulative interest payments that the taxpayers will pay over the life the bonds and loans because districts usually borrow to pay the interest and principal on qualified loans. The taxpayers are obligated to continue levying the millage to repay the loans from the State, which may persist many years after the related bonds are repaid. While the statute requires the loans to be paid within six years of the repayment of the bonds, many districts will not be able to meet this deadline, based on current taxable value projections. This will increase the interest charged to local districts and the long-term costs to the State and could potentially result in the withholding of School Aid payments.

The local millage also is more stable for districts with qualified loans. The millage for these districts remains at the original computed millage determined by the Department of Treasury unless the local district decides it is necessary or advantageous to levy a higher millage. In contrast, districts with nonqualified debt or debt millage less than seven mills, adjust their debt millage annually to ensure debt service is paid. Under current law, local districts with qualified loans can refinance their loans and build new projects without increasing the millage rate. Taxpayers are informed in the ballot language that the duration of the millage will be longer; however, because in many cases the district's millage rate remains the same, concerns have been raised that with the same level of millage continuing, taxpayers may not have sufficient information on the amount and duration of district debt service payments for qualified bonds and loans.

The program also has significant opportunity costs. The State must pay to raise the funds needed to lend to local districts. The State's debt service on the general obligation bonds is paid from the School Aid Fund. With a limited amount of School Aid Fund revenue, the use of funds for this purpose reduces the amount available for other school aid, higher education, and community college costs currently paid from the School Aid Fund. These debt service costs affect all school districts to some degree, whether or not they are benefitting directly from qualified loans, because it decreases the funds available for the foundation allowance and other programs. Some have argued that this is unfair because some districts may be borrowing much larger amounts than others and have better facilities, taking out loans that will not be repaid for many years and creating a drain on the School Aid Fund. Paying the State debt service costs from the General Fund as was done before FY 2002-03 would alleviate pressure on the School Aid Fund but would increase competition for limited General Fund revenue.

Because the use of the program is primarily in the hands of the local districts and their voters, the State has limited ability to deny bond qualification or reduce the costs of the program. For a district that already is levying the maximum 13 mills for debt service (Detroit Public Schools), the Constitution requires the State to lend the district the amount needed in excess of the local revenue on 13 mills in order to make the debt service payments; thus, the debt service millage on qualified bonds and loans for a district already levying 13 mills can never go up as long as the Constitution remains unchanged. Under the current program, costs of any additional qualified bonds are transferred to the qualified loan program for many years. The cost of the program from the School Aid Fund for FY 2012-13 is currently estimated at \$120.4 million and is projected to increase.

Under the current program, the State funding is distributed based on local applications and choices, as opposed to being targeted to districts based on some measure of need. Both the willingness to pay and the ability to pay for school facilities vary significantly among districts. A 2009 study published in the *Journal of Education Finance* estimated disparities within Michigan under the current capital funding system by looking at within-state variation of capital outlays

across school districts from 1998 to 2002. Of the lower 48 states, only eight were found to have greater intrastate inequality in per-pupil capital spending than Michigan's, after adjustments for regional cost differences and poverty.⁵

Closely related to the disparities in per-pupil capital spending in Michigan, is the disparity in fiscal capacity across the State; that is, the difference in ability to raise funds for capital outlay purposes between those districts with the lowest taxable value per pupil and those with the highest taxable value per pupil. In 2011, the average taxable value per pupil of districts in the top 10.0% of districts statewide (based on per-pupil taxable values) was approximately 6.6 times greater than that of districts in the bottom 10.0%. This means that in 2011, to raise the same amount (per pupil) for a capital funding project, the average district in the bottom 10.0% would have had to tax itself at a rate 6.6 times that of the average district in the top 10.0% (based on a pupil-weighted median within percentile ranges). This concept is explored later in this paper and is illustrated in [Table 6](#).

In addition to funding and fiscal capacity disparities between school districts is the level of unmet capital need that has accumulated over the years. Unmet capital need is the expenditure needed to bring each district in the State up to a standard of adequacy (or, the difference between adequate capital stock and existing capital stock). That standard, in this case, is based upon the recommended square footage per pupil, according to The Council of Educational Facility Planners International. As such, in 2005 the Center for Community and Economic Development at Michigan State University estimated total capital need in Michigan to be \$7.6 billion. This means that even if ongoing capital expenditures were to be fully funded, Michigan school facilities would still maintain \$7.6 billion in estimated deficiencies.⁶ This concept is addressed again in the section on options for a State-funded capital investment program.

MICHIGAN SCHOOLS: CAPITAL PROJECTS FUNDING OPTIONS

Given the current issues with the State's School Bond Qualification and Loan Program, the Michigan Legislature may decide to modify the program. Actions could involve altering the existing bond qualification system or creating an entirely new system. The following sections summarize some of the changes that could be made to the existing system, including those changes proposed by S.B. 770, and the hypothetical impact on the SLRF of an increase in the statutory minimum debt millage rate required for school districts to participate in the program. The sections below also explore options the Legislature could consider if it were to implement a new system of capital funding, including the different distribution mechanisms available and funding levels that might be required to offer State assistance for school district capital expenditure.

Altering the Existing System

Senate Bill 770 et al.

A package of bills currently before the Michigan Legislature would modify the existing State system of support for school capital outlay, the SLRF. Senate Bill 770 (S-3) (tie-barred to S.B. 771 and 772) as passed by the Senate on June 7, 2012, would limit access to the SLRF to

⁵ Wen Wang and William D. Duncombe, "School Facilities Funding and Capital-Outlay Distribution in the States", *Journal of Education Finance* Vol. 34, No. 3 (Winter 2009): 340.

⁶ David Arsen and Thomas Davis, "Underinvestment in Capital Facilities of Michigan's Urban Schools: Dimensions of the Problems and State Policy Options", *Urban Policy Series Report I* (Center for Community and Economic Development, Michigan State University, Fall 2008): 9.

reduce future State costs and require districts to recalculate their debt mills annually to ensure that qualified bonds and loans were repaid on time.

Senate Bill 770 (S-3) would establish a cap of \$1.8 billion on the amount of qualified loans outstanding. Specifically, the bill would prohibit the prequalification of a proposed bond issue that would result in additional qualified loans if the State Treasurer determined that the outstanding balance of all qualified loans, including principal and interest, exceeded \$1.8 billion. After the cap was reached, if it were expected that the district would need qualified loans from the State in order to meet its debt services payments on the new bond issue, the bond would not be prequalified. If projections showed that a district would not need qualified loans, the bonds still could be qualified even if the cap had been reached. Although this cap would not restrict those with outstanding qualified bonds from taking out qualified loans after the limit was reached, it would restrict new entrants into the program. The State Treasurer also would have the authority to deny prequalification of a proposed bond issue approved by the voters after September 30, 2012, if the Treasurer determined that the bond issue would have an adverse financial impact on the school district, the State, or the SLRF.

The bill also would set a date 72 months after qualified bonds were due in which repayment of all qualified bonds and loans of a school district would be mandatory; this date would be known as the "final mandatory repayment date". No additional bonds would be qualified for the district unless they could be repaid by the existing final mandatory repayment date. This would result, in many cases, in a district's repaying a previous bond issue and associated loans before being qualified for a new bond issue, unless the district could afford to pay for the new bond issue by the repayment date established for the first bond issue. This change essentially would prohibit the current practice of refunding qualified loans in new bond issues to extend the repayment date. Bonds and loans still could be refunded to achieve economic savings; however, the "rollover" of qualified loans into a new bond issue would be eliminated.

Districts with qualified bonds or loans would be required to recalculate at least annually the millage rate needed to pay the principal and interest on qualified bonds and loans by the final mandatory repayment date. Districts would be required to levy the revised computed millage. Currently, computed millage for qualified bonds is determined once at bond issuance.

To comply with these changes, a district that planned to borrow for additional capital expenditures could reduce the size of the subsequent bond issue or increase its computed millage rate to pay for the new bond issue by the existing mandatory repayment date. Alternatively, the district could consider issuing a nonqualified bond to fund a needed project. All of these responses would reduce State costs, although the local cost of nonqualified debt could well be higher than that on qualified debt.

Generally, this policy option seeks to reduce State and local districts' projected future costs, through the combination of fewer qualified bonds, the prohibition against "rollover" of qualified loans, a unified repayment date, and adjusted millage rates to generate sufficient revenue to make the final mandatory repayment date on qualified bonds and loans. Future debt issued by the State would be reduced due to both the loan cap and millage recomputation described above. The cap would produce an estimated 26-year period in which districts could not issue qualified bonds if those districts anticipated a need for qualified loans from the State. It is anticipated that the proposed cap of \$1.8 billion on all outstanding loans (applicable when districts sought to prequalify bonds and anticipated the need for qualified loans) would be

reached in 2014.⁷ After that date, no new bonds would be qualified if it were anticipated that the bond issue would require loans from the State, until about 2040, when the Department of Treasury projects that the level of outstanding loans will fall below \$1.8 billion. Districts that did not anticipate needing qualified loans still would be able to issue qualified bonds.

Annual recomputation of the millage rate necessary to ensure that qualified bonds and loans would be paid by the mandatory repayment date would increase local millage levies above the seven-mill statutory minimum for some districts, increasing local tax revenue and, with debt repaid sooner, reducing long-term debt service costs to those districts. Depending on local taxable value and debt service requirements, other districts would remain at seven mills. The millage recomputation and the requirement that all outstanding bonds and loans be consolidated in terms of meeting one repayment date could result in greater year-to-year variations in local millage rates paid by taxpayers within a school district than under current practice. Local debt service costs in the future would depend on the degree to which they shifted to nonqualified bonds or delayed or reduced the size of construction projects. The Department of Treasury estimates a reduction in State debt service costs of \$2.2 billion over the next 35 years if this legislation were to be enacted.⁸

Testimony on this package of bills raised concerns regarding the constitutionality of these proposed changes. There is the potential for litigation regarding several issues, including the legality of the cap on loans, the degree to which the Legislature can delegate authority to the State Treasurer to limit access to the program, and whether the State can require districts to recompute their millage rates for qualified bonds that already have been issued. The Department of Treasury has testified that these changes are constitutional.

Senate Bills 771 (S-1) and 772 (S-1) are tie-barred to S.B. 770. Senate Bill 771 (S-1) would revise Public Act 112 of 1961 (State Loans to School Districts) to allow the State Treasurer to accept assignment of loans from or loan repayments to the School Loan Revolving Fund. Repayments would follow the assignment of loans, for example, to the SLRF. It would add language specifying that the State Administrative Board would apply the proceeds of sales of bonds, notes, or commercial paper issued under the act that were issued to reimburse the State or the Michigan Finance Authority. Senate Bill 772 (S-1) also deals with the assignment of loans and loan repayments. It would authorize the Michigan Municipal Bond Authority to assign School Bond Loan Fund loans and loan repayments to the State. It also would remove the limit on the amount of qualified bonds that the Authority may purchase from school districts. Currently, the purchase of qualified bonds by the State may not exceed 7.5% of the principal amount of the qualified bonds issued the previous year by school districts.

Senate Bill 870 (S-1) is not tie-barred to the other bills, but has moved with them. It provides that a district could not prequalify a bond unless it would not result in additional loans until five years after all previous loans had been repaid. Senate Bill 870 (S-1) was passed by the Senate on June 7, 2012.

Raising the Minimum Debt Millage Rate

Another policy option to limit State costs is to increase the statutory minimum debt millage rate required for school districts to participate in the School Loan Revolving Fund. This likely would

⁷ Michigan Department of Treasury, "State of Michigan School Bond Qualification and Program: Senate Bills 770, 771 & 772" (presentation dated December 6, 2011): Appendix C.

⁸ Michigan Department of Treasury, "State of Michigan School Bond Qualification and Loan Program: Senate Bills 770, 771 & 772" (presentation dated December 6, 2011): 8.

reduce the amount that local school districts borrow from the State. It could be applied to districts with newly qualified bonds and potentially to districts already in the program, if it were determined that their millage rates could be changed after bond qualification, as proposed in S.B. 770 (S-3). In 2011, at the minimum debt millage rate of seven mills, the State had loaned \$182.4 million from the SLRF to 97 local school districts.

Raising the minimum millage would increase the local revenue allocated to debt service payments for many districts. If a district is currently levying more debt mills than the proposed statutory minimum, however, that district would be unaffected by an increase in the mandatory minimum debt millage rate, until the proposed rate exceeded the amount that district is currently levying. In the case of Detroit Public Schools, the district currently is levying the constitutional maximum debt millage rate (13) and thus, would not be affected by any increase in the minimum rate.

The additional local revenue that could be raised under various minimum statutory millage rates was estimated using local school district taxable value and millage data for the 2011-2012 school year and school district borrowing from the SLRF in calendar year 2011. Using that base year data, the following analysis considers the question of how State loans would have varied had a higher minimum millage rate been in effect at the time the bonds were qualified, assuming the same local debt service costs as in 2011. While this analysis indicates the potential revenue that would have been available from increasing the minimum millage rate, it does not calculate the actual impact on State costs. Future State costs for this program would depend on the actual local borrowing under the proposed program, the local taxable values at that time, the credit conditions at the time of bond issuance, and the cost of the State funds used for loans.

Table 5 shows how the volume of State loans might have changed if a higher statutory minimum debt millage rate had been in effect for year 2011, and applied to the participants in the SLRF at that time. The table illustrates that as the proposed minimum millage is increased, districts receive higher revenue on their local debt millages and thus have less need to borrow from the State. As the minimum debt millage increases, the number of districts projected to need qualified loans declines. The columns show how many districts are estimated to have continued borrowing from the Fund, the reduction in the amount borrowed from the State, and the level of remaining borrowing, had the minimum debt millage rate been increased. For example, a one-mill increase in the minimum millage would have reduced State loans by approximately \$25.5 million, if the higher minimum millage were applied to all current SLRF participants.

Table 5
Estimated Impact of a Higher Minimum Millage to
Participate in the School Loan Revolving Fund
(Dollars in Millions)

Proposed Statutory Minimum Millage	Estimated Number of Districts Borrowing	Estimated Additional Local Revenue/ Reduced State Loans	Estimated Remaining State Loans
7 (current law)	97	N/A	\$182.4
8	88	\$25.5	156.9
9	75	55.9	126.5
10	55	81.4	101.0
11	33	100.4	81.9
12	18	111.6	70.8
13	12	118.7	63.6

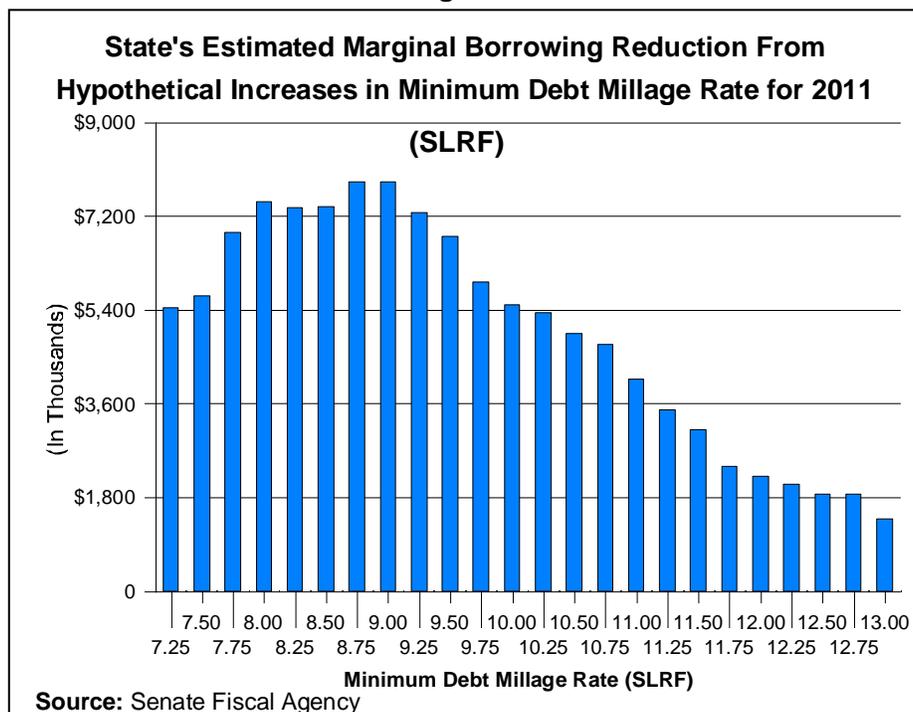
Source: Senate Fiscal Agency

In 2011, 88.0% of all districts borrowing from the SLRF were levying between seven and nine debt mills, and 95.0% were levying between seven and 10 debt mills. Because such a large proportion of schools levy mills closer to the seven-mill minimum, the amount of additional reduced borrowing with every millage increase is not constant; the State would see the most rapid reduction (due to a minimum debt mill increase) in annual borrowing occur when the minimum debt millage rate was increased to approximately nine mills, with subsequent marginal borrowing reduction declining between approximately nine and 13 mills. Figure 6 illustrates the marginal reduction in State borrowing as the minimum debt millage rate increases. It is important to note that this figure is based on 2011 SLRF borrowing; districts and actual levels of borrowing would vary from year to year.

The height of each bar represents the additional reduced borrowing from the SLRF with every 0.25 minimum debt mill increase. For example, the figure shows that in 2011, an increase in the minimum from seven to nine mills might have generated \$55.9 million in additional revenue for districts (borrowing reduction), while an increase in the minimum from nine to 11 might have generated \$44.6 million in additional revenue (\$100.4 million total increase from seven to 11 mills). While every incremental increase in the minimum debt millage would produce additional revenue, not every incremental increase would produce the same amount of additional revenue. In this case, an increase from seven to nine mills would have created a greater marginal gain (in terms of borrowing reduction for the State) than an increase from nine to 11 mills; hence, the downward trending marginal borrowing reduction starting at approximately nine mills.

This figure does not account for districts that may be unable to pass a bond issue at the increased minimum millage rate and subsequently would not be able to participate in the SLRF. These hypothetical scenarios assume the statutory minimum debt millage rate was increased before 2011 and that existing participants in the SLRF were required to abide by the increase.

Figure 6



Implementing a New System

The Legislature could consider an entirely new system of school facility funding designed to meet specific policy goals. These could include addressing unmet capital needs of schools across the State, reducing the disparity in fiscal capacity for capital funding among Michigan school districts, and eliminating the costs and issues associated with the School Loan Revolving Fund. Providing State aid for capital spending would bring Michigan into the majority of states in the U.S. that provide aid for new capital spending. Establishing such a system would resemble the changes to operational funding vis-à-vis Proposal A, as it would be a shift from local funding to a centralized or partially centralized funding structure.

The current system, a credit enhancement program with costs driven by local decisions and economic conditions, could be partially or fully replaced with a funding mechanism that offered State aid to support capital investment. Generally speaking, appropriations for State aid for construction facilities could be distributed to local districts in the form of matching grants, lump-sum grants, or a combination of matching and lump-sum grants. Examples of other options include State assistance to fund specific high-priority projects or complete State funding for new facilities. Depending on the goals of the new program, it could implement a greater degree of State control of school facilities spending. Through the allocation of State aid to school districts, the State could be able to begin equalizing the disparity in fiscal capacity for capital funding between districts at the upper and lower ends of the funding spectrum. Additionally, funding could be directed toward those schools with the most unmet capital need.

Matching Grants

A matching grant program for school facilities generally takes the form of State funding to districts that levy a certain level of local millage. A State appropriation would be distributed to eligible districts by providing a specified level of State funding to match each mill of a local levy. This basic structure could be adjusted to calculate match rates based on a formula, limit the number of mills eligible for State match, or focus the program on districts that met some measure of need.

Providing State aid to school districts in the form of matching grants would maintain some local responsibility for funding capital projects, while giving the State an opportunity to support those local funding measures by offering various matches based on policy choices of the Legislature. The match rate could be prorated based on a number of factors, including capital need (due to crowding or facility age/condition) and taxable value per pupil in the district. The purpose of adjusting the match for taxable value disparities would be to curb the tendency of matching grants to exacerbate the funding disparity issue across districts.

Local ability to raise property tax revenue is based on differences in taxable values per pupil. Table 6 illustrates that in Michigan, the average taxable value per pupil of districts in the top 10.0% of districts statewide (based on per-pupil taxable values from 2011) was approximately 6.6 times greater than that of districts in the bottom 10.0%. This means that in 2011, to raise the same amount (per pupil) for a capital funding project, the average district in the bottom 10.0% would have had to tax itself at a rate 6.6 times that of the average district in the top 10.0% (based on a pupil-weighted median within percentile ranges).

Table 6

Fiscal Capacity of Michigan's Local School Districts in 2011			
District-Taxable Value per Pupil Percentile¹⁾	Number of Pupils	Average Taxable Value per Pupil²⁾	Tax Effort Required for \$1,000 per Pupil Capital Investment
0% - 10%	188,905	\$109,035	9.2 mills
10% - 25%	156,976	\$146,716	6.8 mills
25% - 50%	411,281	\$184,858	5.4 mills
Median	N/A	\$202,036	4.9 mills
50% - 75%	456,739	\$246,413	4.1 mills
75% - 90%	189,796	\$363,448	2.8 mills
90% - 100%	28,510	\$716,065	1.4 mills
¹⁾ Percentile ranges of the rank-order of all 549 Local Educational Authorities (LEAs), based on taxable value per pupil. For example, 0% - 10% represents the 55 LEAs with the lowest taxable value per pupil statewide. ²⁾ Pupil weighted median within the corresponding percentile range			

Source: Senate Fiscal Agency

Using a straight matching grant could exacerbate this disparity issue. For example, suppose District A with a taxable value of \$110,000 per pupil and District B with a taxable value of \$800,000 per pupil both wanted to improve capital facilities and therefore approved a five debt mill proposal. With no State match and with both districts willing to contribute the same percentage of assessed property value to school capital expenditure, District B would generate \$3,450 per pupil more than District A. Because District A's taxable value per pupil is only approximately 13.8% of what District B's taxable value per pupil is, the match rate for District B would need to be 13.8% or less than that of the match rate of District A, in order to prevent widening the disparity in fiscal capacity between those two districts. For instance, if the State issued a 15.0% match rate (instead of 13.8%) for District B and a 100% match rate for District A, with the same five-mill proposal, District B would generate \$3,500 per pupil more than District A (including State funds): a \$50-per-pupil greater difference than with no State aid match.

If the State were to fully equalize the level of funding for districts' school facilities statewide, based on a matching grant distribution mechanism, the level of State match offered to districts with the lowest taxable values per pupil would be considerably greater than the match offered to districts with the highest taxable values per pupil. For example, looking at the same District A and District B from the above example, District B's taxable value per pupil is 727.3% of what District A's taxable value per pupil is. Therefore, to fully equalize these two districts' funding ability for capital expenditure, the minimum State match rate that could be offered is 727.3% for District A and 0.0% for District B. In terms of dollars, the State would match every \$1 raised at the local level in District A with approximately \$7.27 of State aid.

Another aspect of using a matching grant is whether to make the grant closed- or open-ended; that is, whether to set a limit on the amount of funding or number of projects that could be funded in each district. If the State chose an open-ended matching system, it still could place a cap on the amount the State was willing to contribute to an individual project within a district. Among the states participating in a matching grant system for public school capital expenditure, open-ended grants are far more common than closed-ended grants.⁹

Revenue to support the program could come from existing State sources or from a new earmarked revenue source such as a statewide millage dedicated for school capital

⁹ Wen Wang and William D. Duncombe, "School Facilities Funding and Capital-Outlay Distribution in the States", *Journal of Education Finance* Vol. 34, No. 3 (Winter 2009): 331.

improvements. A small statewide infrastructure millage could replace portions of future local debt millages to fund such a program.

Lump-Sum Grants

The State could choose a lump-sum grant option to fund capital projects. A system of lump-sum aid would eliminate some or all of the need for districts to raise funds for capital projects locally, by replacing some or all local effort with State funding for such projects. Lump-sum grants can be distributed in a nonequalizing or an equalizing fashion. Nonequalizing lump-sum aid would provide districts with flat grants at the same level across districts, such as \$100 per pupil. While this might ensure equal funding per pupil, it might not ensure adequate levels of funding for districts or taxpayer equity.

The State could fund school capital in a way similar to that of school operations through an equalizing lump-sum grant program. Compared with the matching grant program, a lump-sum grant system may be better at addressing the disparity of capital funding across districts by allowing a district's ability to pay for capital projects to more closely match the district's willingness to pay or need for capital projects. A statewide infrastructure millage (perhaps newly termed the "State Infrastructure Tax" or "SIT") could be levied on all property currently subject to the State Education Tax and could replace the revenue of local debt millages. A formula to determine highest priority could be placed in statute using factors such as type of project (e.g., renovation or new construction), level of need based on crowding, existing age or condition of buildings, and taxable value per pupil in the district, or a board could be established to determine those districts that would have funding priority.¹⁰ In theory, by eliminating local borrowing costs, including locally accrued interest and additional costs associated with capital improvement projects funded outside the State qualified bond approval process (nonqualified and limited tax bonds), the State could eventually fully fund capital projects without any need to borrow. This would, however, require a sufficient up-front investment to eliminate some of the significant current unmet capital need statewide and possibly the debt service of local districts; this initial capital investment would most likely be funded through the sale of general obligation bonds.

Both Matching and Lump-Sum

The State also could consider a capital funding system that combines both matching and lump-sum grants. This type of system would most likely be more complex than a straight matching or lump-sum system, but would offer the Legislature a wider array of funding options. Maintaining a portion of funding in the form of lump-sum grants could allow the Legislature to chip away at the fiscal capacity discrepancy between districts, while the matching portion would allow local districts to maintain some control over capital funding. Examples of combined matching and lump-sum grant capital investment programs other states have adopted include:

- A flat per-pupil lump-sum grant with a matching grant to assist with the difference between the project cost and the per-pupil flat grant.
- A lump-sum grant directly appropriated by the legislature or based on critical/emergency facility needs, with a matching grant for subsequent capital projects.
- A lump-sum grant to fund general facilities with a matching grant to supplement a percentage of local debt service associated with other capital investment.

¹⁰ Wen Wang and William D. Duncombe, "School Facilities Funding and Capital-Outlay Distribution in the States", *Journal of Education Finance* Vol. 34, No. 3 (Winter 2009): 336.

- An initial per-pupil lump-sum grant with an equalizing matching grant for districts levying an optional specified local millage rate. Those districts levying a local millage are then offered an additional lump-sum grant based on a district's remaining unmet capital need.

Ultimately, the various systems of capital funding vary drastically across states, with many systems deliberately chosen to address the most pressing capital issues in a particular state's education system.

Public-Private Partnerships

Some school systems in the United States, Canada, and the United Kingdom are exploring the use of public-private partnerships (PPPs) (also referred to as alternative financing and procurement) to address school construction needs.

Public-private partnerships generally refer to involvement of the private sector in a public sector infrastructure project that goes beyond contracting for construction. The spectrum of models extends to projects entirely built, operated, financed, and owned by a private company operating on a contract with a public sector partner. In between these endpoints are variations in leasing, public purchasing of facilities at a later point in the contract, operation, and maintenance. These agreements are regarded as a way to shift or share risks between the public and private sectors. Under traditional school construction models, the local district assumes costs and associated risks for design, financing, maintenance, the lifecycle of the facility, and the availability and performance of the asset. The private sector typically is involved in construction and the construction schedule. An example of an alternative structure is one in which a private company is engaged to design, construct, operate, and maintain a school facility on a long-term contract, with costs and performance measures included in the contract. In this case, the risks and potential cost changes associated with the long-term operation and availability of a school building are assumed by the private company. In theory, the district has more stable costs and less daily oversight responsibilities for the structure. The district, or perhaps a third party, assumes the risk that the private-sector partner remains solvent.¹¹

The process used in Ontario evaluates the potential for savings from using a PPP by comparing the projected costs under a traditional procurement model (known as the "public sector comparator") with the projected costs in an alternatively financed and managed project. Key assumptions include the value of the risk transferred to the private sector through alternative financing and procurement.

The Yonkers Public School District (Yonkers, NY) has entered into a contract with financial and construction advisors to develop a PPP approach to its significant unmet infrastructure needs. This is reportedly the first social infrastructure PPP for a public school district in the United States, including the rehabilitation of 40 school buildings and costing approximately \$1.7 billion.¹² The Michigan Department of Treasury (under the former Office for Public Private Partnerships) previously contracted for preliminary research exploring this approach and the potential of PPPs to help districts plan, construct, and maintain school facilities.

¹¹ Pi-Chu Chiu, "Risk Management Strategy for Infrastructure Public-Private Partnership Projects", presentation at CRGP, Stanford University, accessed September 20, 2012, http://crgp.stanford.edu/publications/articles_presentations/PiChu_Chui_Risk_Management_Strategy_for_Infrastructure.pdf.

¹² KPMG International, "Infrastructure 100: World Cities Edition", accessed September 26, 2012, <http://www.kpmg.com/AU/en/IssuesAndInsights/ArticlesPublications/Documents/infrastructure-100-world-cities-edition.pdf>: 22.

Options for a State-Funded Capital Investment Program

Just as Proposal A implemented a system whereby the State attempted to meet unmet operational funding needs and reduce funding disparities by taking greater control over the supply of operational funds, there are several contrasting ideas for State-level support for school district capital needs and existing school district debt. The scenarios discussed below illustrate the variety of options available to the State and the possible State costs, which depend on the comprehensiveness of the proposal. In the most comprehensive scenario, school districts would no longer issue debt for capital expenditures or acquire additional SLRF loans to finance debt service. State funding is considered for three basic areas: 1) to replace existing local school district debt, 2) to reduce or eliminate accumulated unmet school capital needs, and 3) to meet ongoing annual capital funding needs. While the universe of potential approaches to address capital needs and district debt is virtually unlimited, the approaches presented here focus on more active State-level solutions.

In the scenarios discussed below, the State would issue bonds to raise funds to pay for all or a portion of school district capital expenses. The issuance of State general obligation bonds for this purpose would require voter approval. A dedicated statewide funding source would repay the bonds and pay ongoing capital expenditures. As with Proposal A, taxation would shift from the local level to the State level. The State would distribute funds to local school districts for ongoing needs. The details of a distribution formula are not addressed but could be developed based on the ideas presented previously regarding lump sum and matching proposals. With full State funding of capital spending, this would essentially be a lump sum distribution of State aid. If the system provided partial funding, then elements of a matching distribution formula could be used.

The tax shift in these options from local to statewide taxes would create the opportunity to reduce disparities in fiscal capacity and facility quality among school districts. To the extent that the State can issue bonds at a lower interest rate than most local districts can, projects could be completed and debt refinanced at a lower cost. By eliminating additional SBLF loans, the proposals would eliminate future State debt service costs for that program and reduce local debt service costs incurred by borrowing from the State to pay debt service on bonds. This current practice can rapidly increase a local district's interest costs on a given project.

The options below outline variations in State-level funding for existing obligations and unmet capital needs. All options include fully funding ongoing capital expenditures.

Option 1, Full State Funding: The State would issue bonds to replace local debt for capital expenditures including qualified loans, as well as to pay for unmet capital needs. Ongoing needs would be met from current-year State revenue. Under this option, the State would pay off outstanding SBLF/SLRF loans and existing district debt, based on the existing balance. All tax rates to cover debt service and ongoing costs would be highest in the first year of bond repayment and decline each year until the bond was repaid.

Option 2, State Refunding of Existing School District Debt: The State would issue bonds to cover all existing district debt. Unmet capital needs would not be addressed, but presumably would be covered over time under ongoing needs. Ongoing needs would be met from current-year State revenue. The State would pay off outstanding SBLF/SLRF loans and existing district debt, based on the existing balance. All rates to cover debt service and ongoing costs would be highest in the first year of bond repayment and decline each year until the bond was repaid.

Option 3, State Funding of Unmet Capital Needs: The State would issue bonds to cover only unmet capital needs. Existing debt would not be covered by the bond and districts with debt, including SBLF/SLRF debt, would be paid off from existing local levies. Ongoing needs would be met from current-year State revenue. All rates to cover debt service and ongoing costs would be highest in the first year of bond repayment and decline each year until the bond was repaid. While this option addresses both unmet and ongoing capital needs, it creates an issue for servicing existing debt, especially in cases where the SBLF/SLRF is used. Under this option, given the assumption that no additional loans would be issued from the SBLF/SLRF, affected districts would either need to be required to levy additional mills to cover debt, or be allowed to direct some portion of their distributions for unmet needs and/or ongoing needs to service their existing debt, or be subject to some combination of these two options; or some other mechanism would be needed to cover debt service costs in these districts.

Option 4, State Pays Unmet Capital Needs and Refunds Local Bonds: This option is identical to Option 1, except that the State would not pay off SBLF/SLRF debt. Debt associated with the SBLF/SLRF would continue to be paid from existing local levies. All rates to cover debt service and ongoing costs would be highest in the first year of bond repayment and decline each year until the bond was repaid.

Option 5, State Refunds Existing Bond Debt: This option is identical to Option 2, except that the State would not pay off SBLF/SLRF debt. Debt associated with the SBLF/SLRF would continue to be paid from existing local levies. All rates to cover debt service and ongoing costs would be highest in the first year of bond repayment and decline each year until the bond was repaid.

A number of assumptions were used to estimate the impact of these options. Existing local school district debt is assumed to total \$16.8 billion based on 2011 data from the Department of Treasury. Ongoing capital needs are assumed to total \$1.0 billion per year, and to grow at 4.0% per year, based generally on historical demand. Unmet capital need is assumed to be \$7.6 billion, using a 2005 estimate of the total statewide unmet capital need (adequate capital stock less existing capital stock) from the Center for Community and Economic Development at Michigan State University.¹³ Some variables of this estimate have changed since 2005, including the market value of existing capital stock, pupil enrollment numbers, and construction costs. The degree to which these forces are offsetting is indeterminate, but this estimate of unmet capital need remains relevant for the purposes of discussion of general funding distribution options. In cases where the State issues debt, repayment is assumed to be in equal annual installments over a 30-year period and while the actual interest rates for such debt are unknown, rates have been assumed for illustrative purposes. The assumed interest rate for State issued bonds is 4.0%. To simplify the analysis, it was assumed that all bonds are issued at one time; however, bond issuance could be phased in over a period of years.

The State could raise revenue for debt repayment or other expenditures by using many new or existing revenue sources. To facilitate a comparison with existing debt mills, the analysis estimates the levy needed to generate the required revenue if the levy were a statewide property tax levied only on real property. To facilitate a comparison with existing earmarks of sales tax and income tax revenue, the results identify the necessary tax rates that would need to be levied to generate the needed revenue, given the current bases upon which these taxes are levied.

¹³ David Arsen and Thomas Davis, "Underinvestment in Capital Facilities of Michigan's Urban Schools: Dimensions of the Problems and State Policy Options", *Urban Policy Series Report I* (Center for Community and Economic Development, Michigan State University, Fall 2008): 9.

The tax bases for each revenue source are assumed to grow over time. Taxable value is assumed to grow at 3.5% per year. Without new construction or home sales, which trigger increases in taxable value, taxable value tends to grow at the same rate as inflation, which is currently expected to average roughly 3.0% per year over the next 30 years. The assumed growth rate for taxable value is slightly less than the 1995-2011 average of 3.7% per year and well below the 1995-1997 average of 5.5%--possibly the only period since the approval of Proposal A that did not coincide with a Michigan recession or a speculative financial bubble. The income tax base is expected to grow at 4.3% per year, which equals the 1981-2011 average, while the sales tax base is expected to rise at 4.4%, which is the average annual rate at which disposable personal income grew over the 1981-2011 period.

The impact of options described above is summarized in Table 7. The various revenue sources in the table (property, income, or sales tax) show the projected tax effort required if each source is chosen to fully fund the program option independently of one another. Because of growth in the tax bases used to generate revenue, as well as growth in the cost of ongoing needs, tax rates needed to meet revenue needs are not constant over time. Table 7 lists the estimated maximum rate that must be levied to generate the needed revenue, as well as the average rate over the 30 years of the bond repayment, and the rate in the first year after the bond is completely repaid. Generally, rates are highest in the first year in which bond repayment begins, and lowest once the bonds are paid off and only ongoing capital needs must be funded. However, several options attempt to limit the maximum tax rates or significant swings in rates by bonding for portions of the initial ongoing needs. In these cases, the maximum rate is generally five years after the bond issue. Option 1 is the most comprehensive proposal to shift costs to the State. Under each option, after the initial bond was repaid, the tax rate would fund ongoing costs only and would be the same across all options.

While Table 7 presents the fiscal impact of the options in aggregate terms, it does not provide a comparison to current costs. To make an accurate comparison, in aggregate terms, would require data not available for this report. However, in order to provide such a comparison, and to evaluate the sensitivity of the results to certain assumptions, several stylized "sample" districts were created. The results are presented in Table 8.

For the hypothetical districts, high-debt districts are assumed to have \$500.0 million in debt, while low-debt districts have \$150.0 million in debt. Qualified debt that can qualify for the SLBF/SLRF if needed under current law is assumed to represent 90.0% of the total debt. In order to simplify the analysis, the debt issued is assumed to represent the cumulative outstanding debt of the hypothetical districts although it is represented here as though it were a single debt issue. High unmet capital needs are assumed to total \$250.0 million, while low unmet capital need totals \$25.0 million. In the high-taxable-value-per-person district, taxable value equals six times the debt while in the low-taxable-value-per-person district, taxable value equal three times the debt. Bond issues are assumed to pay a 4.0% rate. For the current law estimates, the examples compute the approximate local cost of a 30-year bond issued at the assumed debt amount. For the State options, the examples estimate the State cost of covering the debt amount and/or the unmet needs amount. This would be a tax shift from local to State, and in many cases a lower cost. Under these hypothetical examples, the interest rate assumptions are particularly important. As the economy improves and interest rates increase, the various options are likely to offer cost savings regardless of the characteristics of the individual districts.

In Table 8, the line for "Current Law – Local District Costs" shows the estimated interest cost that would be paid by a local district on its debt for bonds and qualified loans. The top half of the table shows a variety of hypothetical districts all assumed to have a low taxable value per pupil. The sample districts differ by the amount of outstanding debt and the amount of remaining unmet need. The first two columns show a relatively high-debt district assumed to have \$500.0 million in outstanding debt. In the first column the amount of unmet need is assumed to be \$250.0 million, illustrating that considerably more improvements are needed. In the second column, the unmet need is only \$25.0 million. In both cases, the interest cost on \$500.0 million in outstanding debt is estimated at \$941.5 million. Because this is assumed to be a district with a low taxable value per pupil, the district needs qualified loans from the State, which increases the total interest costs for the district. Current costs are relatively low for the "low debt" districts on the right side of the table because they are assumed to have \$150.0 million in debt outstanding, considerably less than the \$500.0 million assumed for the high-debt district. The current law examples do not include any borrowing for the unmet capital needs.

The amount of unmet capital need in the district becomes important in the options to shift costs to the State. In Option 1, where the State would take over repayment of outstanding debt and the funding of unmet needs, the estimated interest cost to the State for a long-term borrowing that covers the \$500.0 million in debt plus \$250.0 million in unmet need is approximately \$501.1 million. Moving down the column, the estimates illustrate that the State interest cost can be divided between the parts of the proposal. The State cost of Option 2 is the interest cost of refunding the district's outstanding bonds and loans. The State cost of Option 3 is for State interest costs for bonding to pay the cumulative unmet capital needs. Local districts would continue to pay the current cost of retiring their existing bonds and loans. Under all of the options for the hypothetical low-taxable-value districts, the interest costs are lower for the State than for the school district, even with additional spending to cover previously unmet capital needs. This reflects the lower interest rate received by the State and the avoidance of the additional costs of qualified loans.

The lower half of the table applies the same options to hypothetical districts with high taxable value per pupil. The State costs of each option are the same as in the previous examples because they reflect the same amounts of State borrowing. The current law estimates, however, are much lower than in the examples for low-taxable-value districts. This reflects the higher revenue yield per mill and the resulting lower need for qualified loans. In each case, for high-taxable-value districts the State could refund the existing district debt (Option 2) and achieve savings due to reductions in the interest rate and the amount of qualified loans. In the case of the high-debt district with a low unmet need, the savings are great enough to cover the State payment of the unmet capital needs. In the other three scenarios for high-taxable-value districts, the savings are not large enough to cover the entire amount of unmet need.

In these examples, the State refunding of school debt results in a reduction in interest costs. The savings in these illustrations are greatest for districts with relatively low taxable values. For higher taxable value districts, the savings from State refinancing would be lower but still potentially significant. These examples illustrate the potential for cost savings for both State and local school districts from replacing the SBLF/SLRF program.

Table 7

Projected Statewide Tax Rates Needed for Bonding Options and Ongoing Capital Needs										
Option	Amount Bonded (billions)	Property Tax Rate (mills)			Income Tax Rate			Sales Tax Rate		
		Maximum	Average During Bond	After Bond is Paid	Maximum	Average During Bond	After Bond is Paid	Maximum	Average During Bond	After Bond is Paid
1. Existing debt plus unmet needs	\$24.44	8.08	6.67	4.05	1.34%	1.00%	0.53%	1.92%	1.41%	0.74%
2. Existing debt only	\$16.84	6.66	5.76	4.05	1.10%	0.86%	0.53%	1.58%	1.22%	0.74%
3. Unmet needs only	\$7.60	4.93	4.66	4.05	0.82%	0.69%	0.53%	1.17%	0.98%	0.74%
4. Existing debt, less SBLF debt, plus unmet needs	\$23.16	7.84	6.51	4.05	1.30%	0.97%	0.53%	1.86%	1.38%	0.74%
5. Existing debt, less SBLF debt	\$15.56	6.42	5.61	4.05	1.06%	0.84%	0.53%	1.52%	1.18%	0.74%

Note: All options include \$1.0 billion for ongoing capital spending. In Option 3, local school districts would continue to levy millage to retire existing debt. In Options 4 and 5, locals would levy mills only to repay SBLF debts.

Source: Senate Fiscal Agency

Table 8

Estimated Local and State Interest Costs of Various Debt and Unmet Need Scenarios in Hypothetical Districts (dollars in millions)							
Description/Option	High Debt		Low-Taxable-Value-Per Pupil Districts		High-Taxable-Value-Per Pupil Districts		Low Debt
	High Unmet Need	High Unmet Need	High Debt	Low Debt	High Debt	Low Debt	
Current Law – Local District Interest Costs for Existing Debt	\$941.5	\$941.5	\$941.5	\$282.6	\$369.4	\$110.8	\$282.6
<u>Options – State interest costs for:</u>							
1. Existing debt plus unmet needs	\$501.1	\$501.1	\$350.8	\$267.3	\$350.8	\$267.3	\$116.9
2. Existing debt only	\$334.1	\$334.1	\$334.1	\$100.2	\$334.1	\$100.2	\$100.2
3. Unmet needs only	\$167.0	\$167.0	\$16.7	\$167.0	\$16.7	\$167.0	\$16.7
<u>Current Law – Local District Interest Costs for Existing Debt</u>							
	\$369.4	\$369.4	\$369.4	\$110.8	\$369.4	\$110.8	\$110.8
<u>Options – State interest costs for:</u>							
1. Existing debt plus unmet needs	\$501.1	\$501.1	\$350.8	\$267.3	\$350.8	\$267.3	\$116.9
2. Existing debt only	\$334.1	\$334.1	\$334.1	\$100.2	\$334.1	\$100.2	\$100.2
3. Unmet needs only	\$167.0	\$167.0	\$16.7	\$167.0	\$16.7	\$167.0	\$16.7

Source: Senate Fiscal Agency

OTHER STATE SYSTEMS

This section aims to provide a general explanation of public school capital outlay funding in other states, specifically focusing on their funding mechanisms, and the extent of state involvement. The quantitative data reported in this section reflect specific financial reporting and data collection practices in the respective states unless otherwise noted.

Of the states surrounding Michigan, Ohio has developed a matching grant program to fund capital outlay, while Indiana promotes public school construction through other means. Both states' close geographic proximity to Michigan make them interesting for comparison. On the east coast, Massachusetts has developed an extensive competitive grant-based capital funding system, making the state's system appropriate for comparison with Michigan's substantially different approach to facility funding.

Ohio

The Ohio Supreme Court ruled in 1997 that school facilities construction in Ohio was underfunded and that it was a responsibility of the state to ensure proper learning environments for students (*DeRolph v. State, 1997*). As a result, the State of Ohio overhauled its public school facilities funding system, establishing the Ohio School Facilities Commission (OSFC) to oversee and administer a state matching grant program to fund public school construction.¹⁴ Currently, the OSFC employs approximately 66 staff members, all of whom are considered state employees.¹⁵ Ohio appropriated \$8,550,000 for agency operating costs in FY 2012-13.¹⁶

Ohio's flagship school construction program, the Classroom Facilities Assistance Program (CFAP), grants money to local school districts for the construction of a facility's "master plan". The master plan is tailored to meet all of the district's capital needs, not just the construction or renovation of a single building. In order to receive the state grant, a school district must first raise the required local portion. Inclusion in the program and the state's match rate are both determined by the Eligibility Rankings list -- a list published annually by the Ohio Department of Education, ranking school districts based on equity. The Eligibility Rankings formula takes a rolling three-year average of the taxable property value of the district divided by the adjusted Average Daily Membership. Every year, the Department of Education uses this method to give Ohio school districts a ranking, placing districts into percentile groupings 1 through 100. The districts with the lowest taxable value per pupil receive priority funding, requiring them to raise the lowest local portions. For most districts, the required local portion is equal to the total cost of the project multiplied by their percentile ranking; for example, a school district in the 10th percentile must raise only 10.0% of the total estimated costs.¹⁷ Once districts receive funding

¹⁴ State of Ohio. School Facilities Commission. "Looking Forward, Looking Back, Looking in the Mirror: Executive Director's Review of the Ohio School Facilities Commission", *Columbus: OSFC* (2007), accessed July 25, 2012, http://osfc.ohio.gov/Portals/0/PDFs/20070503_minutes_attachment.pdf: 2.

¹⁵ State of Ohio. Department of Administrative Services. "State Employee Salary Data" (June 2012) accessed July 25, 2012, <http://das.ohio.gov/Divisions/HumanResources/HRDOCBPolicy/StateEmployeeData/StateEmployeeSalaries.aspx>.

¹⁶ State of Ohio. Legislative Service Commission. "Budget Detail: Main Operating Budget Bill, As Enacted", *Columbus: LSC* (2011) accessed June 25, 2012, <http://www.lsc.state.oh.us/fiscal/bid129/budgetindetail-hb153-en-fy11actexp.pdf>: 72.

¹⁷ State of Ohio. School Facilities Commission. "FY 11 School Facilities Eligibility Ranking List", *Columbus: OSFC* (2010), accessed July 25, 2012, <http://osfc.ohio.gov/LinkClick.aspx?fileticket=fByACFXUkBQ%3d&tabid=78>.

from CFAP and complete their master plan, they are not eligible to receive more CFAP funding for the life of the buildings (50 years). The OSFC aims to address every school's capital funding needs; that is, CFAP is designed not to fund only high-poverty school districts, but to assist every school district in the state, starting with those districts with the greatest need. Currently, Ohio's capital outlay program is approximately 50.0% complete, as the OSFC has offered funding to nearly half of all districts in the state. If a district's voters do not approve a bond issue and tax levy within 13 months of the School Facilities Commission's conditional approval of a project, the encumbrance of State funds for a project is lapsed. Those state funds then are offered to other eligible districts, and those districts for which funding lapses have first priority for funding in the future.

In total, Ohio appropriated \$1,025,469,400 for the OSFC FY 2012-13 budget (as enacted). This includes \$675.0 million in capital funding, \$341.9 million for general obligation debt service, and \$8.6 million for operating expenses.¹⁸ Bonds backed by the General Revenue Fund (GRF) are currently the primary revenue source for the program; historically, the program also has relied on tobacco settlement funds and cash transfers from the GRF and other funds. Most of the capital funding will be distributed under the Classroom Facilities Assistance Program according to the equity ranking system, but some of the funding will go to districts qualifying under the Exceptional Needs Program to replace or renovate buildings due to crowding, health concerns, or other extraordinary circumstances. Instead of being prioritized based on equity, districts in the Exceptional Needs Program are assessed based on facility need. School districts further down the ranking list may still begin constructing their approved master plan design without initial CFAP funding under the Expedited Local Partnership Program. Whatever money the district spends on the plan will count toward its required local portion when the district is finally accepted into CFAP. When offered funding, school districts do not have to accept—they can defer funding and choose not to build, or they can choose to finance their capital projects locally. The fourth program under the Ohio School Facilities Commission is the Vocational Facilities Assistance Program. The OSFC can use up to 2.0% of its yearly appropriation on projects under this program. These projects provide assistance to joint vocational school districts for the acquisition of classroom facilities, based on district equity.

Massachusetts

The State Legislature of Massachusetts created the Massachusetts School Building Authority (MSBA) in 2004 in order to replace a previous capital funding system that was considered inefficient. The former system had been created as a temporary school funding source in 1948, but was extended years beyond its originally intended expiration date, accumulating more than \$11.0 billion in unfunded promises to districts.¹⁹ Many of the statutes and changes implemented in the MSBA governance language were designed to address problems encountered under the former program.

As an authority, the MSBA is not under the control of a government agency. Instead, government agency leaders serve as members of the authority's board, with the State Treasurer serving as chairperson. The purpose of the MSBA is to provide financial assistance to city, town, and regional school districts to finance the costs of approved school capital projects. The MSBA board has the sole authority to approve school project applications and to create

¹⁸ Ohio General Assembly. House. *Revised Code*, HB 153 and HB 482, 129th General Assembly.

¹⁹ Commonwealth of Massachusetts. School Building Authority. "2010 Needs Survey Report", *Boston: MSBA* (2011), accessed July 25, 2012, http://www.massschoolbuildings.org/sites/default/files/edit-contentfile/Our%20Programs/2010_Needs_Survey_Report_29April2011.pdf: 8.

program guidelines in addition to those provided in statute. The application process is based upon a competitive matching grant system. While the MSBA is bound by a statute-based priority approval list, discretion to interpret and apply that list remains with the authority.

The first step for a school district seeking funding in Massachusetts is to fill out a Statement of Interest. If the authority determines the Statement of Interest meets the necessary requirements, the district and the MSBA arrive at a Project Funding Agreement. This agreement specifies the state share of the project costs, which is determined by a statute-based formula. The matching grant system is closed-ended in that the state has a limit on the amount of grants approved for projects in a year. That limit was \$500.0 million in FY 2007-08, with each subsequent fiscal year limited to the previous year's limit plus the lower of the growth rate in dedicated sales tax revenue amount, or 4.5%. The formula calculated for each project grant begins with a base percentage of 31.0% and adds to that base a Community Income Factor, a Community Property Wealth Factor, a Community Poverty Factor, and an optional Incentive Percentage. The Incentive Percentage is granted by the MSBA based on factors other than a community's ability to pay, such as a district's use of efficient construction delivery methods or energy efficient and sustainable design. Despite the formula, no grant can cover less than 31.0% or more than 80.0% of the project cost.

In 2010, the MSBA's expenditures totaled \$1.1 billion, including \$818.4 million on grant payments to school districts, \$290.8 million on debt service and issuance costs, and \$8.4 million in administrative costs. In 2010, over 93.0% of revenue for the MSBA came from dedicated state sales tax (currently, statutorily earmarked at 1.0%). While the authority's total liabilities outweighed total assets by \$6.3 billion as of 2010, much of the debt and accrued interest traces back to honoring promised payments to districts under the state's former system.²⁰

Indiana

The State of Indiana, similar to the State of Michigan, does not provide state aid for districts' capital improvement projects. Instead, funding for such projects comes from the effort of local school districts, termed "school corporations" in Indiana law. Indiana does, however, issue advancements to school corporations for capital improvement purposes. These advancements are made from the state's Common School Fund and are to be used for school building construction purposes, educational technology programs, and charter schools' operational costs. Revenue for the Common School Fund comes from various fines and forfeitures, unclaimed funds, and escheated estates. Within this fund are three distinct programs related to capital expenditure: the School Technology Advancement Account, Educational Technology Program, and School Building Construction Program.

The School Technology Advancement Account and Educational Technology Program make loans to school corporations to develop and implement innovative technology projects, and acquire, operate, and train teachers to use educational technology equipment. To qualify for a loan, a school corporation must develop a three-year technology plan containing a number of required elements. For both programs the state places a maximum on the amount that may be loaned to each school corporation each year, with an interest rate set between 1.0% and 4.0%, and an established repayment schedule of two to five years, depending on the amount of the loan. The School Technology Advancement Account also places a cap on the amount that may

²⁰ Commonwealth of Massachusetts. School Building Authority. "2010 Annual Report", *Boston: MSBA* (2010), accessed August 17, 2012, http://www.massschoolbuildings.org/sites/default/files/edit-contentfile/Publications/MSBA2010AR_updated.pdf

be loaned statewide, each year. If the aggregate amount of petitions for loans exceeds the cap, the loans are prorated based on the number of petitions and the petitioners' adjusted taxable value per pupil; those with the lowest taxable value receive first consideration when the loans are granted.

The School Building Construction Program provides advancements from the Common School Fund to school corporations or school townships for the purposes of purchasing, leasing, or financing land, the construction and equipping of school buildings, and the remodeling, repair, or improvement of school buildings. A corporation or township must meet one of two main qualifications to receive the advance: sustained loss by fire, wind, cyclone, or other disaster of all or a major portion of a school building or buildings, or an adjusted taxable value per pupil within the lowest 40.0% of all school corporations and school townships statewide. Generally, loans made under this program cannot have a repayment period exceeding 20 years or an interest rate greater than 7.5%. In 2010, five school corporations qualified and received a combined \$11,519,687 in loans under this program.²¹

In addition to the Common School Fund and its capital-related programs is the recently created Charter School Facilities Assistance Program. This program provides grants and loans to charter schools for the purpose of constructing, purchasing, renovating, or maintaining school buildings, paying first-semester costs for new charter schools, matching Federal grants, and reducing Common School Fund debt. The term of a loan from the Charter School Facilities Assistance Fund cannot exceed 15 years, with the interest rate and other terms of the loan determined by the State Board of Finance.

CONCLUSION

Since 1955, the State of Michigan has offered qualified loans to local districts to assist with debt service payments on qualified bonds. The constitutional language that requires the program has been amended twice, most recently in 1963. The Legislature has made numerous revisions to the implementing statutes in an effort to adapt the program to current policy goals and economic conditions, including a major rewrite in 2005; however, the costs of the program are still projected to increase. Estimates of future costs have risen substantially in the last few years as local taxable values have declined in this difficult economy. While the current program provides benefits to local school districts in the form of stable millage rates and credit enhancements, it does not address directly the disparity in the quality of school facilities among districts. It transfers local costs temporarily to the State, until they are repaid, perhaps not for decades. Therefore, the cost of the program to the School Aid Fund is driven by local decisions to take out qualified loans and local economic conditions that affect the pace of loan repayment. Those local decisions have a statewide impact as the State debt service costs on general obligation bonds have become the first draw on the School Aid Fund, preempting funding that otherwise would be available for other programs including the foundation allowance.

Bills currently before the Legislature would sharply curtail the availability of qualified loans. Under S.B. 770 (S-3), the qualified loan program would be closed to new entrants after the proposed cap of \$1.8 billion in qualified loans was reached, expected to occur in 2014. Projected continued high demand for qualified loans by districts already approved for the program means that State savings would remain relatively insignificant for a number of years. It

²¹ State of Indiana. Department of Education. "Digest of Public School Finance in Indiana: 2011-2013 Biennium", *Indianapolis*, accessed June 28, 2012, <http://www.doe.in.gov/sites/default/files/icsb/public-sch-digest-2011-2013-final.pdf>: 41-43.

is expected that savings would not exceed \$10.0 million annually until FY 2019-20, but would continue to rise, resulting in approximately \$2.2 billion in State debt service savings over the next 30 to 40 years. The impact of the limited access to qualified loans on school construction, facility quality, and local capital costs would depend on local decisions on how to respond to the proposed financing environment.

Other types of programs could be considered to provide State support for school construction. As long-term tax credits were recently replaced by annual appropriations for economic development, a new program to assist school construction could be designed to operate based on annual appropriations or a limited amount of State-issued bonds. This type of change would place decisions on State spending at the State level. A constitutional amendment would be required to repeal the current system of credit enhancements for local school district construction projects; however, a new program could either replace or operate in addition to the current constitutional requirement. A system of infrastructure aid could be developed to reflect policy decisions regarding the amount to spend, the types of districts to assist, and the types of school infrastructure to support. There are many options involving various degrees of State control and financing that could be considered. Distribution mechanisms such as a matching fund program could treat all districts equally or be targeted based on measures of need. A program could be developed specifically for Michigan or based on models from other states.

Funding for any replacement or enhancement program would depend on the availability of State revenue and difficult decisions regarding competing uses for State General Fund and School Aid Fund dollars. Another option would be to consider a dedicated statewide revenue source for school capital expenditures. For example, a statewide property tax on real property could be levied, or a portion of State income or sales tax could be dedicated for capital projects. This would be a tax shift from the local to the State level. Depending on which funding option was chosen, a new statewide millage or increase in income or sales tax would replace a portion or all of local debt millage for current and future projects. The impact of such a wide-ranging change would vary by local district and the scope of the program.

With the long-term nature of indebtedness for qualified bonds and qualified loans, decisions made now regarding the operation of and limits on these programs will affect the State budget and local school districts for decades in the future. Similarly, school buildings are assets that serve communities for decades. Determining an effective way to finance these assets could improve budget stability for the State and local school districts and enhance local school district operations.

Michigan Constitution of 1963

Article IX, Section 16

§16 State loans to school districts.

Sec. 16. The state, in addition to any other borrowing power, may borrow from time to time such amounts as shall be required, pledge its faith and credit and issue its notes or bonds therefor, for the purpose of making loans to school districts as provided in this section.

Amount of loans.

If the minimum amount which would otherwise be necessary for a school district to levy in any year to pay principal and interest on its qualified bonds, including any necessary allowances for estimated tax delinquencies, exceeds 13 mills on each dollar of its assessed valuation as finally equalized, or such lower millage as the legislature may prescribe, then the school district may elect to borrow all or any part of the excess from the state. In that event the state shall lend the excess amount to the school district for the payment of principal and interest. If for any reason any school district will be or is unable to pay the principal and interest on its qualified bonds when due, then the school district shall borrow and the state shall lend to it an amount sufficient to enable the school district to make the payment.

Qualified bonds.

The term "qualified bonds" means general obligation bonds of school districts issued for capital expenditures, including refunding bonds, issued prior to May 4, 1955, or issued thereafter and qualified as provided by law pursuant to Section 27 or Section 28 of Article X of the Constitution of 1908 or pursuant to this section.

Repayment of loans, tax levy by school district.

After a school district has received loans from the state, each year thereafter it shall levy for debt service, exclusive of levies for nonqualified bonds, not less than 13 mills or such lower millage as the legislature may prescribe, until the amount loaned has been repaid, and any tax collections therefrom in any year over and above the minimum requirements for principal and interest on qualified bonds shall be used toward the repayment of state loans. In any year when such levy would produce an amount in excess of the requirements and the amount due to the state, the levy may be reduced by the amount of the excess.

Bonds, state loans, repayment.

Subject to the foregoing provisions, the legislature shall have the power to prescribe and to limit the procedure, terms and conditions for the qualification of bonds, for obtaining and making state loans, and for the repayment of loans.

Power to tax unlimited.

The power to tax for the payment of principal and interest on bonds hereafter issued which are the general obligations of any school district, including refunding bonds, and for repayment of any state loans made to school districts, shall be without limitation as to rate or amount.

Rights and obligations to remain unimpaired.

All rights acquired under Sections 27 and 28 of Article X of the Constitution of 1908, by holders of bonds heretofore issued, and all obligations assumed by the state or any school district under these sections, shall remain unimpaired.