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Debt for School Facilities: Trends and Issues

Texas school districts pay for their facilities through local property-tax collections, short- and long-term debt, state assistance programs, federal grants, and corporate contracts and donations. Over the past decade, as districts have addressed pent-up demands to expand and upgrade their facilities, school debt has grown substantially, especially for fast-growth suburban districts.

Since 1992, voter-approved debt for Texas schools has increased more than eightfold, to nearly \$29 billion. School districts are taking longer to pay their long-term debt, and statewide school debt is approaching the maximum amount that can be guaranteed by the Permanent School Fund (PSF) under state law and federal tax rules.

The state has assumed an increasing portion of the debt service on school bonds since the Legislature created two assistance programs in the late 1990s. Some observers say these programs are largely responsible for the increase in school districts' bonded indebtedness. At the same time, many districts regard these programs as the most significant tax relief they have received in years, and they say the programs are essential in the absence of other changes in the school finance system.

Voter-approved debt has grown substantially as school districts strive to meet demand for facilities and the state has assumed a share of the debt service on school bonds.

As school districts issue more bonds, many are counting on the state to continue to help them pay their debt on facilities. This report focuses on trends in bonded-debt financing for school facilities, statutory restrictions on school debt, and how state assistance for facilities has affected school districts' debt load. It also examines some related policy issues that lawmakers may consider during the 78th Legislature.

School debt trends

Education Code, sec. 45.001 authorizes the issuance of voter-approved bonds with a maturity of 40 years or less, to be repaid with ad valorem tax revenue, for (1) building, acquiring, and equipping buildings; (2) acquiring or refinancing real or personal property; (3) buying school building sites; and (4) buying new school buses.

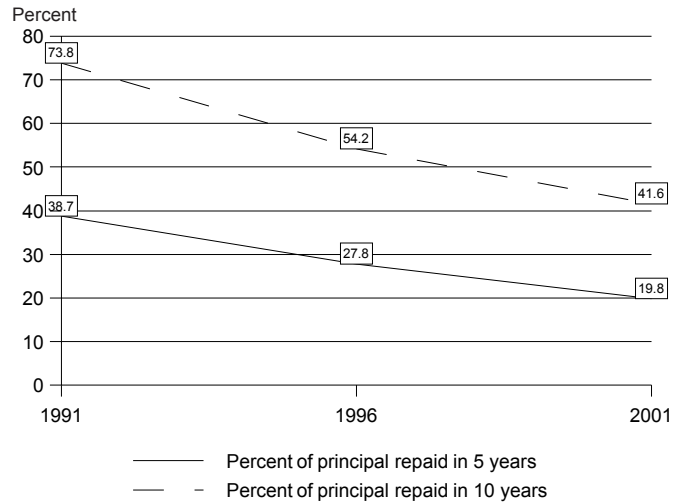
Ninety-six percent of school debt is issued in the form of general obligation bonds. Some other debt instruments used by school districts include capital appreciation bonds, lease-purchase revenue bonds, and short-term maintenance tax notes. Revenues from taxes that a district imposes to pay for bonded debt go into an interest and sinking (I&S) fund.

In the past decade, bonded debt for Texas' more than 1,000 school districts has risen significantly. Although the number and percentage of districts with debt actually have declined, both statewide debt per capita and debt per student in districts that carry debt have more than doubled, according to the Bond Review Board (BRB). Also, schools are repaying debt principal only about half as quickly as they did 10 years ago. (See graph, page 2, and table, page 3.)

As pent-up demand for school facilities grew and the state assumed more of the debt burden, Texas school districts' per-capita debt more than doubled from 1992 to 2001, from a statewide weighted average of \$477 to \$1,146. The ratio of local school debt to assessed property valuation in districts with debt also doubled, from 1.45 percent to 2.93 percent.

As of October 31, 2002, the principal value of 2,874 bond issues outstanding in Texas school districts totaled nearly \$29 billion, according to the Municipal Advisory Council of Texas. About \$26 billion was guaranteed by the PSF, which is managed by the State Board of Education with the help of investment advisors and Texas Education Agency (TEA) staff. In the past two years alone, school districts' bonded debt has risen by about 30 percent. Since September 1, 2001, voters have approved about three out of four school bond elections, although only half of the bond elections held for athletic facilities have passed, according to the BRB.

School Debt Repayment Trends



Note: Repayment of 25 percent of principal in five years and of 50 percent in 10 years is considered average.

Sources: Bond Review Board and State Auditor's Office.

Debt restrictions

In 1955, the 53rd Texas Legislature limited the amount of bonded debt a school district could issue to between 7 and 10 percent of the assessed valuation of taxable property. For each percentage point that the ratio exceeded 7 percent, a district had to reduce its tax rate for maintenance and operations (M&O) by 10 cents per \$100 of valuation. In 1981, lawmakers changed the limit to a flat 10 percent of assessed valuation. The 1995 enactment of SB 1 by Bivins repealed that statute and redefined the state's method for limiting local bonded debt; however, a few school districts remain limited by outstanding bond covenants to debt levels of about 7 percent of assessed valuation.

Fifty-cent rule. State law generally limits a school district's M&O tax rate to \$1.50 per \$100 of valuation. (Under Art. 2784g, enacted before the creation of the Education Code in 1969, a district in a county with more than 700,000 residents may impose an M&O tax rate not to exceed \$2.00.) A more flexible guideline exists for I&S (debt) taxes, called the "50-cent rule."

Before issuing bonds, a district must demonstrate to the attorney general that it can repay the principal and interest on the proposed bonds and on all other bonds issued since September 1, 1992, without exceeding

Texas Public School Districts' Voter-Approved Debt, 1992-2001

	8/31/92	8/31/01
Principal amount guaranteed by Permanent School Fund	\$3 billion	\$24 billion
Number of districts with debt	724 (69%)	669 (65%)
Debt per student* (districts with debt, weighted average)	\$2,793	\$6,664
Debt per capita (statewide weighted average)	\$477	\$1,146
Debt to assessed valuation (districts with debt, weighted average)	1.45%	2.93%

* Based on average daily attendance.

Source: Bond Review Board.

an I&S tax rate of 50 cents per \$100 of valuation (Education Code, sec. 45.0031). The attorney general must count both local tax revenue and state aid for debt service when calculating a district's ability to pay for a bond. Once the attorney general approves a bond issue and local voters pass it, a district's I&S rate can rise above 50 cents if property values decrease. Thus, despite the \$1.50 cap on M&O tax rates and the 50-cent test for I&S tax rates, a school district's total tax rate may exceed \$2.00 per \$100 of valuation.

Policy issue: Shifting operating expenses to I&S.

According to unaudited 2002 nominal tax rates reported to the comptroller, more than 400 school districts have reached the \$1.50 M&O cap. As more districts reach that cap, some may be shifting financing for certain items (other than salaries and benefits) that could be considered operating expenses away from M&O and into I&S. SB 1671 by Jackson, enacted in 2001, supports districts in this practice by authorizing the use of bonds to pay for new school buses, an item that previously had to be paid out of M&O or through maintenance tax notes.

Anecdotal evidence suggests that some Chapter 41 districts — wealthier districts that must return money to the state for redistribution to poorer districts — have found it advantageous to shift maintenance costs to I&S as a way of avoiding recapture. Because the state formulas for calculating recapture consider only the M&O tax levy, wealthier districts can bring in more dollars per penny on the I&S tax levy, since they are not required to return I&S money to the state.

TEA publishes the Financial Accountability System Resource Guide to help school districts maintain proper budgeting and financial accounting and reporting systems. Sec. 1.2.4.2 generally defines a capital asset as a piece of equipment or furniture with a unit cost of at least \$5,000 and a useful life of more than one year; however, some flexibility exists within this rule. According to the TEA accounting guide, "Instead of charging certain transactions under supplies and materials, a school district may decide to group purchases of items costing less than \$5,000 per unit under a major replacement or equipping program." Observers say that some districts may be using this provision to change the definition of a capital asset and/or to bundle less durable items into groups that could be counted as capital assets. As items are reclassified as capital assets, some may become eligible for financing with long-term debt rather than from M&O funds.

Supporters say this practice is consistent with Education Code, chapter 46, which allows bonds to be issued for building and equipping new facilities. They say it makes fiscal sense to cover the entire cost of furnishing new facilities with a single large bond issue, especially when the cost of debt is so reasonable. It is logical to bond library books, computers, carpets, and other items that may not be considered capital assets in accounting terms, as long as this practice passes legal muster with the attorney general, they say. With M&O tax rates capped at \$1.50, school districts need greater budgetary flexibility to work within the constraints of the existing school finance system. As long as the debt is voter-approved and the bond issue explicitly

states what is being funded with I&S taxes, the debt transaction is open and subject to public approval. Furthermore, they say, bond issues typically are structured as a mix of short- and long-term bonds so that school districts pay for short-term assets appropriately with short-term bonds.

Others counter that it is not fiscally prudent to issue 30-year bonds for items such as computers that have a useful life of less than five years. School bonds were intended to pay for high-dollar projects involving fixed assets, they say, not for cheaper durable goods that must be replaced. Allowing bonding for such items without limiting bond terms could tempt some school boards to issue too much debt. A wiser policy for financially struggling districts, they say, would be to perform an audit and to benchmark the district's per-capita debt cost against that of other districts, to see whether other management practices are causing the district to bump up against the M&O tax cap.

Within five years, school debt could reach the maximum amount that can be guaranteed by the Permanent School Fund under state law.

Guaranteed bond program. In 1983, Texas voters approved a constitutional amendment that allows the state to use the PSF to guarantee school bonds (Texas Constitution, Art. 7, sec. 5(b)). Use of the fund to guarantee repayment in case of district default is intended to make school bonds a more attractive investment and to reduce interest rates and other costs. Amendment supporters correctly predicted that backing local bonded debt with the PSF would save school districts millions of dollars in interest and bond-guarantee premium costs by raising school districts' bond ratings. Opponents also correctly predicted that the measure would increase bonded debt by making borrowing a more attractive option for school districts. In the past 10 years, the amount of debt guaranteed by the PSF has risen more than eightfold.

School districts participating in the PSF bond guarantee program pay a premium of only \$300 per bond issue for bond insurance, compared to an average premium of \$78,000 per issue paid by cities. In fiscal 2001, school districts paid \$68,100 in bond-insurance premiums for 227 bond issues valued at \$5.4 billion. In the same year, cities paid \$16.7 million in bond-insurance premiums for 213 bond issues valued at about \$4 billion.

Education Code, sec. 45.053 limits the amount of debt that can be guaranteed to 200 percent of the cost value or the market value of the PSF (excluding real estate), whichever is less. Cost value is what the state paid for its investment; market value is what the state could sell it for in today's market. As of November 30, 2002, market value of the PSF was \$17.2 billion and cost value was \$17.3 billion, according to TEA. Thus, under state law, the current maximum amount of school bonds that could be guaranteed by the PSF is about \$34.4 billion, or twice the fund's market value.

U.S. Internal Revenue Service (IRS) rules limit the bond guarantee program to 250 percent of the lesser of cost or market value, but IRS procedures for calculating cost and market value are complex and different from the state's. According to the State Auditor's Office, for the first time ever in fiscal 2001, the IRS limit became more restrictive than Texas' statutory limit. As of November 30, 2002, under IRS rules, the total amount of school bonds that could be guaranteed by the PSF is \$34.1 billion.

Policy issue: Limit on PSF bond guarantee. Since 1983, when voters approved creation of the bond guarantee program, the amount of school debt guaranteed by the fund has soared. Until a few years ago, the value of the PSF was growing along with the debt. However, after recent stock-market declines, the market value of the PSF has dropped below the cost value for the first time ever, and school bonds are approaching the 200 percent limit. According to the State Auditor's Office, if financial markets continue to decline, the bond guarantee program could hit its statutory limit within five years.

Some say that lawmakers should consider increasing the bond-guarantee limit to 250 percent, generally equivalent to the IRS limit. Such a change would not require a constitutional amendment, only a simple majority vote of both houses of the Legislature to amend the statutory limit.

Supporters of increasing the PSF bond-guarantee limit say the state cannot afford *not* to increase it. The program upholds school districts' bond ratings and lowers interest rates on their bonds by up to one-fourth to

one-half of a percentage point, saving millions of dollars in interest payments over the life of the bonds. They say the bond market is wary of property-poor school districts even with the AAA rating secured by PSF backing. If the bond-guarantee limit were reached and state backing no longer were available, most districts could not qualify for lower interest rates and affordable bond insurance, and poor districts would be hurt the most. Supporters say increasing the bond-guarantee limit would pose little financial risk for the state, as only one Texas school district has defaulted on bonds since the late 1950s. If a district did default, they say, the PSF would be reimbursed from the district's state-aid appropriation.

Opponents of increasing the bond-guarantee limit say that if the state continues to add to the risk of the PSF, it must be prepared to spend part of the fund in the event of a default. They note that since the guarantee program was enacted, many more districts have taken on significant debt and are taking longer to pay their long-term debt. Although rare, a default is possible, especially in regions where the economy is weak or unstable. They say that extracting a reimbursement from a defaulting district by reducing its annual allocation of state aid would hurt local students, who depend on schools to pay teachers' salaries and other expenses out of the district's state allocation.

State aid for school facilities

In the late 1980s, school facilities became an issue in the *Edgewood* series of lawsuits that addressed equity and adequacy in public school funding. In *Edgewood I*, State District Judge Harley Clark predicted that paying for construction of facilities would become a major problem for schools. During a 1990 special session, the Legislature appropriated \$5 million to conduct an inventory of school facilities. According to the comptroller's Texas School Performance Review, the inventory "clearly indicated that Texas districts had significant unmet needs for school facilities, beyond those needed for expected growth in enrollments." A subsequent survey by the comptroller in 1998 revealed the same unmet demand nearly a decade later.

In 1991, lawmakers modified the Foundation School Program to allow school districts to leverage state dollars (Tier 2 funds) for facilities. Tier 2, also called the "guaranteed yield," guarantees a certain

level of state funding based on a district's wealth and its tax effort. In 1999, however, as part of the enactment of other state assistance programs for school facilities, the 76th Legislature disallowed the use of Tier 2 funds for facilities under SB 4 by Bivins.

Texas voters amended the Constitution in 1989 to authorize the issuance of \$750 million in state bonds to purchase local bonds. This provision was intended to respond to concerns that IRS regulations might shut down the PSF bond-guarantee program. It never has been used because of the benefits of the PSF program, which involves only one set of issuance costs and secures a AAA rating, as opposed to the AA rating that would be available to districts through the authorized bond-purchase program.

In 1993, voters rejected a constitutional amendment that would have authorized a different \$750 million state bond program for school facilities. In 1995, the 74th Legislature appropriated \$170 million for a grant program that assisted about 20 percent of school districts through a formula based on wealth and tax effort. However, the program's funding mechanism did not address property-tax relief for poorer districts that were issuing debt to meet facilities needs.

The Texas Supreme Court's 1995 ruling in *Edgewood IV*, while upholding the current system of school finance under which property-rich school districts must share part of their revenue with property-poor districts, criticized the absence of a state program to help with facilities debt. In response, the next two legislatures created programs to help schools pay bonded debt issued for facilities, land, and equipment. Education Code, chapter 46 lays out state formulas and qualifications for the facilities programs.

In 1997, the Legislature created the *Instructional Facilities Allotment (IFA)*, a competitive program that provides guaranteed (equalized) state aid to help qualified school districts pay debt service for new instructional facilities, additions, and renovations. Schools that apply for IFA funds must do so before issuing bonds, and they must match state aid with local taxes. For example, a low-wealth district might qualify for a match of 90 percent state funds with a 10 percent local contribution, while a medium-wealth district might qualify for a 50/50 match. Some districts that normally would not qualify for IFA may qualify if they have experienced rapid enrollment growth over several years. According

to TEA, only 128 of the 326 eligible districts that applied for IFA assistance for the current school year received funds.

In 1999, state lawmakers created the *Existing Debt Allotment (EDA)*, an equalized funding program that helps qualified school districts pay “old” debt, currently defined as debt for which a district made payments before September 1, 2001. Lawmakers in the last session “rolled forward” the eligibility cutoff date to cover two more years of debt. As the EDA rolls forward, it covers any debt that the sum-certain appropriation for the IFA may have “missed” in the previous biennium. EDA is not a competitive program, and no application is required for a district to receive an allotment. Districts with lower wealth per student have a greater share of their debt paid by this allotment. Unlike IFA, the EDA program helps with debt payments for both instructional and noninstructional purposes.

EDA provides a guaranteed yield of \$35 per student per penny of I&S tax effort up to 29 cents per \$100 of valuation. The 77th Legislature raised the cap from 12 cents to 29 cents in 2001, when very few school districts exceeded that rate. However, according to unaudited 2002 tax rates reported to the comptroller, more than 50 districts now impose I&S rates of at least 29 cents.

For fiscal 2002-03, lawmakers appropriated more than \$1.5 billion for equalized facilities under the Foundation School Program: \$534 million for the IFA and \$981 million for the EDA. When these programs were enacted, lawmakers theorized that after an initial surge in debt due to pent-up demand for facilities, debt issuance would subside after several years. That has not occurred, partly because of continuing high enrollment growth and partly because replacement needs for facilities in poor communities were greater than expected.

Although school facilities never have been the primary complaint in a school-finance lawsuit, several of the *Edgewood* rulings have raised the issue. As more districts run out of revenue options, the adequacy of state assistance for school facilities could present a significant equity issue. Recent lawsuits have focused primarily on the issue of school districts’ “meaningful discretion” in funding an accredited education under the current system. As more districts reach their taxing capacity, courts conceivably could determine that control

of local school-tax rates effectively has passed to the state. In that event, the system would be deemed to impose an unconstitutional state property tax. According to the Texas Supreme Court’s ruling in *Edgewood IV*, when a local community reaches the limit of its taxing capacity and the state-imposed tax cap becomes “in effect a floor as well as a ceiling,” meaningful taxing discretion no longer exists. (For more background, see “Taking Stock of School Finance Litigation,” HRO *Interim News* Number 77-8, May 29, 2002.)

Policy issue: Continuing support for EDA. Most school districts support enactment of a provision that would roll forward the EDA eligibility cutoff date automatically each biennium rather than relying on legislative approval during the appropriations process. The current system, they say, leaves districts in doubt as to whether the cutoff date will be rolled forward, making it difficult for them to plan their budgets. They say lawmakers should create a true “debt tier” in the school finance system that would provide ongoing assurance of state support for school facilities and other capital expenditures. The cost of continuing to guarantee all existing debt would be relatively low, they say, because most of this debt already is in the system. Some districts have expressed concern over whether the EDA will be renewed at all. They say that failure to renew the program or to roll forward the eligibility cutoff date could provoke another school-finance lawsuit by creating a major equity issue between richer and poorer districts.

Opponents of automatically rolling forward the cutoff date say the state cannot afford to create another entitlement program. In uncertain economic times, with a looming budget shortfall, they say, it would be unwise to commit a large amount of state resources to a program that was designed to deal with pent-up demand and not necessarily intended to be permanent. EDA is a part of TEA’s baseline budget, they say, and while lawmakers presumably intend to continue to support debt incurred before September 1, 2001, budget writers should retain flexibility as to whether to roll forward the eligibility cutoff date this biennium. In the meantime, they maintain that the PSF bond-guarantee program provides ample state support for school facilities. The growth in bonded school debt since the inception of the IFA, they say, should be a warning to the state to be careful about similar long-term promises regarding the EDA.

Fast-growth districts. Some suburban school districts in major metropolitan areas have experienced annual enrollment growth of 10 percent or more for several years in a row. Examples include Plano, Round Rock, Cypress-Fairbanks (near Houston), and Northside (near San Antonio). These districts face the challenge of providing enough classrooms for all students. To accommodate growth, many of these districts must request waivers of statutory limits on class size and must seek voter approval of bond issues to build more facilities. According to the Fast Growth School Coalition, these 105 districts — about one-tenth of all districts — account for about four-fifths of the growth in Texas' student enrollment over the past five years and for about 70 percent of the outstanding debt accumulated by all Texas school districts.

Education Code, sec. 46.006 authorizes adjustments to school finance formulas to help fast-growth districts qualify for IFA funding. Because districts with lower wealth per student receive preference in IFA funding, the 76th Legislature created a series of graduated formula weights to compensate wealthier districts for enrollment growth of more than 10 percent, 15 percent, and 30 percent. Further adjustments are allowed for districts that have no outstanding debt at the time they apply for assistance. Districts that did not qualify in the past receive an adjustment to help them move up in the rankings in future rounds.

In 2001, lawmakers adjusted the guidelines for the 50-cent rule for I&S taxes to help fast-growth districts. HB 2888 by Truitt allows school districts to ask the attorney general to consider rising property values when calculating a district's future ability to pay back bond issues. Under the new law, school districts may project up to five years forward a growth rate in property values equal to 90 percent of the growth rate over the previous five years. Supporters of this change noted that many fast-growth districts were experiencing property-value growth of up to 30 percent in one year, yet they still had trouble proving that they could pay for bonds under the 50-cent rule. Opponents warned that property values might not continue to rise as quickly as in the past, which could result in I&S tax rates exceeding 50 cents per \$100 of valuation.

Fast-growth suburban districts account for about 70 percent of the outstanding debt for facilities accumulated by school districts across the state.

Related policy issues

Understatement of debt. The State Auditor's Office has noted that school districts' total debt may be understated because of the accretion of capital appreciation bonds (CABs). A CAB is a deeply discounted general obligation (GO) bond that "accretes" interest until maturity. Accretion, the accumulation of capital gains over the life of the bond, represents the difference between the face value of the bond and the original discount price. Instead of paying interest every six months as on a regular GO bond, the issuer promises to pay the principal and interest in the future. A CAB usually is included as one bond among many in a package deal, and the debt-service schedule is structured so that regular bonds mature first and CABs come due at the end. In this way, a school district may reduce earlier payments and make bigger payments later. However, most bond issues structure payments so as to provide steady debt service over the life of the issue.

The problem, according to the state auditor, is that school districts do not report accretion as part of their total bonded indebtedness guaranteed by the PSF. Because the law does not require school districts to set aside interest as they go, a district may accumulate a large future debt but is required only to report the original face value to the bond-guarantee program. For example, a CAB with a face value of \$1 million may be worth \$5 million at maturity, but the district reports only \$1 million to the program. As of October 31, 2002, Texas school districts reported 688 outstanding CABs with a face value of \$2.4 billion and a value at maturity of \$8.1 billion, according to the Municipal Advisory Council.

Opponents of requiring the reporting of accretion on CABs say it is highly unlikely that a default on any of these bonds would cause the system to collapse. They say that calculating accretion is a complicated process and would require intensive data collection by an already overburdened TEA staff. The PSF would be at risk only if every single school district defaulted at the same time. Furthermore, they say, school districts submit audited financial reports to TEA annually with full documentation of their outstanding debt.

Facilities assistance for charter schools. HB 6 by Dunnam, enacted by the 77th Legislature in 2001, authorizes the Texas Public Finance Authority to establish a nonprofit corporation to issue tax-exempt revenue bonds on behalf of open-enrollment charter schools for acquisition, construction, repair, or renovation of school facilities (Education Code, sec. 53.351). The law directs the comptroller to set up a fund similar to the PSF bond guarantee for charter schools. A shell account has been set up, but lawmakers appropriated no funds for it.

Charter school administrators say that because these schools receive no state aid to buy or lease buildings, many have had to seek loans from private management companies at higher interest rates under less favorable terms. Although a bond financing entity now exists for charter school facilities, the entity does not attract outside investors because lawmakers appropriated no

state dollars for it. Revenue bonds are harder to sell than GO bonds, especially for charter schools, mainly because the absence of a tax base makes it harder for a charter school to establish a steady stream of revenue for bond payments. Bonding authority and appropriations should go together, advocates say, and the Legislature should back the guarantee fund with enough money to give the law meaning.

Opponents say that because charter schools have no tax base from which to draw, they should not be eligible for state funds that are already in short supply. They argue that charter schools generally have not proven viable as long-term enterprises and that the state should not guarantee — nor should a private investor buy — long-term revenue bonds for such entities, considering that few of them have been in business for more than five years.

— by *Dana Jepson*

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