State Notes

TOPICS OF LEGISLATIVE INTEREST

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Proposed Changes to the School Bond Loan Fund and a Discussion of Jobs Today for Schools

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Article IX, Section 16 of the Michigan Constitution of 1963 requires the State to make loans to school districts under certain conditions. Over the last four decades, the amount of loans the State has made to districts has grown, and now stands at more than $704.0 million. Because the State must borrow in order to have money to lend, the State incurs debt service costs. These costs grow over time because the rate at which the districts repay the State is slower than the rate at which the State pays back its own debt. This differential in repayment rates causes a drain on the School Aid budget, which in fiscal year (FY) 2005-06 is scheduled to pay $44.5 million in debt service costs for the School Bond Loan Fund (SBLF). The problem of escalating State debt service costs is one reason that the Administration of Governor Granholm has proposed changing the SBLF into a self-sustaining revolving fund. Other issues surrounding school bonding also are addressed in the proposed reform and are discussed below. At the end of the article is a discussion of the schools' portion of the Jobs Today package, which involves the issuance of bonds for school construction, renovation, or demolition.

School Construction in Michigan

When school districts need to issue bonds for construction purposes, they may use a process called "qualification". Qualified bonds are issued for a period of 10 to 30 years, and require qualification by the State Treasurer and approval of the district's voters. Qualification is based on an extensive preliminary review of the project by the Treasurer, including demonstration of project need, reasonable costs, and enrollment projections; projects built with qualified bonds must use prevailing wages and benefits.

If a district's bonds become "qualified", three items are accomplished: 1) The bonds are guaranteed by the State; 2) the district is able to use the State's credit rating when selling its qualified bonds, thereby obtaining a lower interest rate; and 3) if the district's millage levy in any given year is insufficient to pay the principal and interest, the district may borrow the difference from the SBLF.

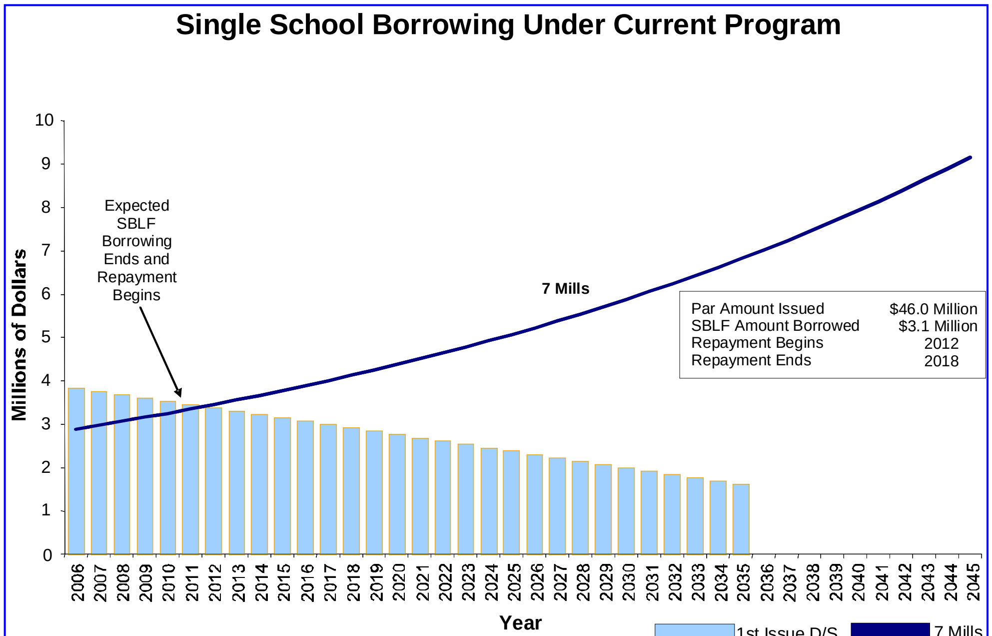
Districts do not need to seek State qualification for their bonds. Out of 553 school districts in the State, 422 districts have sought the qualification process for current bond issues. Most districts that use the qualification process do not borrow from the SBLF. In other words, their millage levies bring in enough revenue to meet the yearly principal and interest payments on their construction bonds. In fact, of the 425 districts that issued qualified bonds, only one-third (147) have borrowed (or are borrowing) from the SBLF and have current balances; as mentioned above, these balances total more than $704.0 million. The other two-thirds of the districts, while not borrowing, still reap the benefit of the State's credit rating via the qualified status of bonds.

The School Bond Loan Fund

In order to borrow from the SBLF, a district first must have issued "qualified" bonds for its construction. Second, the district must levy at least seven mills to pay the interest and principal on those bonds. If the mills levied in any particular year do not generate enough revenue to pay the interest and principal on the qualified bonds, then the district may borrow from the State's SBLF the amount necessary to meet the debt service payment. The loan process continues until the revenue from a district's millage levy exceeds the principal and interest payment on the construction bonds.

At this point, the district uses the excess tax proceeds to begin repayment to the State until the outstanding SBLF balance has been paid. Repayment of SBLF loans must be completed within five years of the district's bonds' maturity date. This process is illustrated below in Figure 1.

Figure 1



Source: Department of Treasury

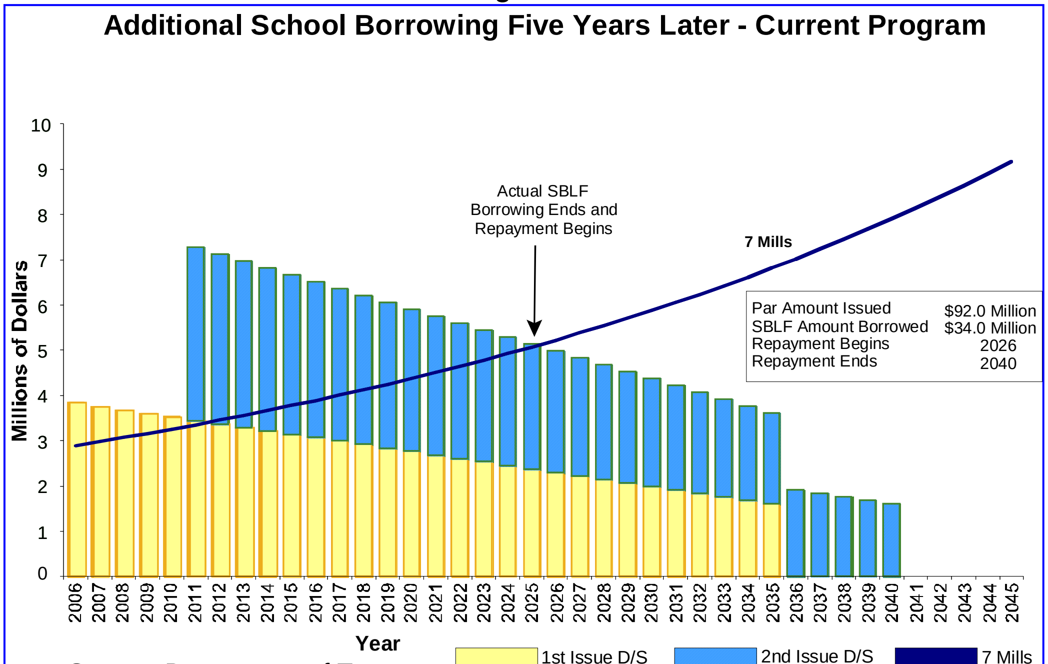
Concerns with the Existing SBLF Program

As mentioned in the introduction, the State incurs debt service costs on the dollars it borrows in order to have money available to lend to school districts in the SBLF program. One would think that the repayments by school districts on money borrowed from the SBLF would be enough to cover the State's debt service costs, but this is not the case. Under current law, districts may postpone repayment of their SBLF debt by obtaining qualification and issuing new bonds on a second construction project *before* repaying the State for the first project's borrowing. This practice is illustrated in Figure 2. Therefore, the State repays its debt more rapidly than it receives payments from districts.

If no change is made to current law to require that districts pay off their current debt before borrowing subsequent times, the anticipated State debt service for the SBLF (currently paid for in the K-12 budget) will reach $200.0 million in 2021, falling to a constant $165.0 million annual cost (using current assumptions) beginning in 2026, as shown in Figure 3.

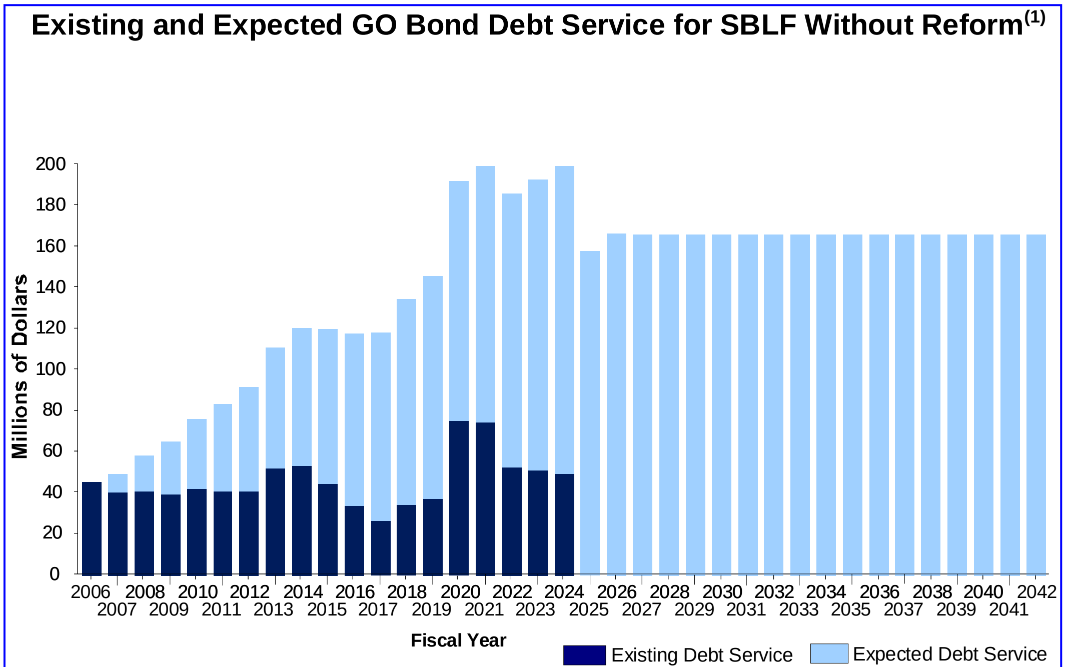
Other concerns with current bonding laws relate to information that districts must provide to voters when deciding a construction question. One of the Administration's goals in reforming the SBLF program is to improve the dialogue between districts and electors. Currently, electors are not made aware that a district may have to continue to levy debt mills after the bonds are paid off if money has been borrowed from the State. Also, electors are not, under current law, informed that the district incurs additional expenses for projects when the district borrows from the State.

Figure 2



Source: Department of Treasury

Figure 3



Source: Department of Treasury
(1) Assumes $100 million total new loans made annually including existing commitments.

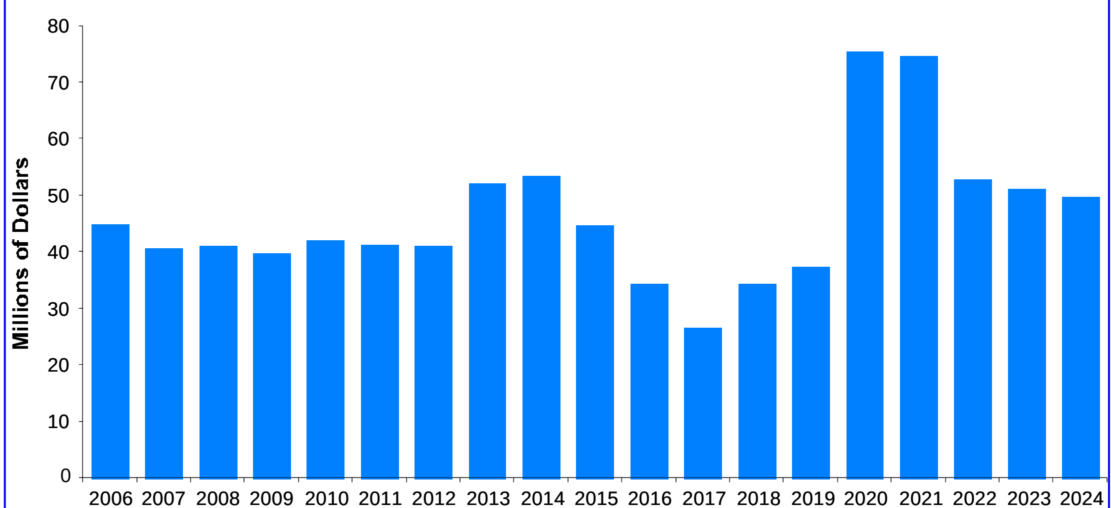
The Proposal – A Revolving Fund and More Voter Information

The Administration is proposing to transform the existing SBLF program into a school bond revolving loan fund. To accomplish this, districts would be required to pay off existing loans from the SBLF using a fixed repayment schedule before they would be able to borrow again. By requiring districts to repay current obligations with a fixed repayment schedule, the State could transform the existing SBLF from a liability into an asset since the State would receive a fixed, reliable income stream. The State then would borrow against that asset, generating an initial estimated $435.5 million in proceeds. These proceeds would be used to deposit $86.1 million into the School Aid Fund to cover debt service on the old SBLF program both in the current fiscal year, 2004-05, and in next year's budget. (This deposit is assumed to balance both the current year enacted K-12 budget and next year's K-12 budget proposal.) At least $300.0 million would be used as the initial capitalization to begin the revolving loan fund. The remaining dollars would be used to cover costs associated with the transformation to a revolving fund, as well as the establishment of a debt service reserve fund.

The fixed repayments from districts on their existing debt under the old SBLF program would be used in two ways: 1) to pay the debt service on the funds provided through the capitalization to establish the new program, and 2) to make dollars available for loans under the new revolving fund. Repayments from districts on money borrowed in the new fund would be used to make new loans as well. In this manner, the revolving fund would be self sustaining and generally would no longer require the State to undertake more general obligation debt and incur more debt service costs. The only cost to the State in the future would be the remaining debt service on previous general obligation debt incurred under the old SBLF program, the cost of which would cease to exist in approximately 20 years. Figure 4 illustrates the declining debt service burden if reform is enacted.

Figure 4

Existing General Obligation Bond Debt Service for SBLF with Reform(1)



Source: Department of Treasury

(1) Assumes 3.50% interest rate costs on variable rate bonds.

Other proposed changes in the program involve requiring districts to provide more information to voters when holding elections for construction bonding. The Administration is proposing that districts be required to place language on the ballot informing voters that the districts may borrow from the SBLF and may have to continue to levy debt mills after the bonds have been repaid.

Jobs Today for Schools Proposal

Governor Granholm has proposed a Jobs Today initiative that envisions the creation of jobs through several types of investments. A component of this is the proposal that a total of $500.0 million of qualified bonds be made available to districts for critical construction, renovation, or demolition of aging school buildings. Districts would be able to issue qualified bonds and not increase their current debt millage for at least the first five years. Districts would borrow the entire debt service payment on those bonds from the State for those first five years. The State would use resources in the newly created revolving fund to make the debt service loans to districts.

Districts that issued qualified bonds under the Jobs Today package would borrow debt service payments from the State and pay 0% interest on those State loans. School districts, except for those levying zero mills now, would not need to levy additional taxes to pay the debt service on their borrowing. The length of time for the levy, however, would be extended for the districts to pay back the bonds issued along with the 0% interest loans borrowed from the State. Those districts levying zero mills today would continue to levy zero mills for the first five years, and beginning in the sixth year would levy the lesser of the mills necessary to make the debt service payment on Jobs Today bonds, or two mills. Voters would need to approve a school district's issuance of bonds for the Jobs Today package. The one exception to this would be if a district chose to issue "budget" bonds for renovation or demolition under this package, and use operating funds (rather than debt millage) to pay the debt service and then repay the SBLF. "Budget" bonds require a notice to voters 45 days before the issuance of bonds, giving voters time to halt the issuance via referendum if so desired.

Under the Administration's proposal, the $500.0 million of qualified bonds would be approved for school districts on the basis of the following (unranked) eight criteria:

- Readiness of the district to issue bonds, as measured by the completeness of design and planning;
- Age and condition of facilities to be renovated, replaced, or demolished;
- Taxable value per pupil;
- Severity of environmental or usability problems such as asbestos abatement, energy conservation, or Americans with Disabilities Act requirements;
- Technology needs;
- Age and condition of the facilities as a whole;
- Overall condition of facilities; and,
- Utilization of classrooms.

The $500.0 million of qualified bonds would be available for two purposes: 1) $320.0 million for renovation or demolition, and 2) $180.0 million for the construction of small high schools. For a district to be eligible to apply for Jobs Today loans to construct one or more qualified small high schools, the district must meet the following criteria: 1) have at least 800 pupils in grades 9 to 12; 2) use the qualified small high school(s) to improve the graduation rate and/or improve achievement in English language arts or mathematics in order to achieve proficiency under the Federal No Child Left Behind Act; 3) adopt a proven model for curriculum and operational structure of the qualified small high school(s); and, 4) adopt a resolution committing sufficient funds from private and public sources to pay for planning and startup operating costs of the new school(s).

Any district could apply for up to $10.0 million for renovation purposes, $10.0 million for demolition purposes, or $15.0 million for the construction of small high schools, but no district would be approved for more than $25.0 million in total qualified bonds under this program. An exception to this would be for districts with more than 20,000 pupils. In their cases, up to $30.0 million would be available for the construction of small high schools, with no more than $40.0 million approved in total qualified Jobs Today bonds. Also, if there were no flood of applicants during the first six months, the Department of Treasury is proposing that it be allowed to increase loans to existing applicants for all three purposes (renovation, demolition, and small high school construction).

Three years are planned by the State to approve the $500.0 million in qualified bonds, with construction work on approved projects beginning before December 31, 2007. It is estimated by the Administration that this portion of the Jobs Today package would create approximately 8,000 jobs.

It is important to note that the SBLF reform discussed earlier can be a stand-alone project. The Jobs Today for Schools package does not need to be enacted in order to accomplish reform of the SBLF. However, if the Jobs Today for Schools package *is* enacted, in order to avoid General Fund debt service costs, either the revolving fund itself, must be created by reform of the existing SBLF program, or excess district repayments into the revolving fund must occur.