

# INNOVATIVE METHODS TO FUND PUBLIC SCHOOL CONSTRUCTION

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*This paper was written to support the Task Force to Study Public School Facilities mandated by Senate Bill 856 passed in the 2002 Maryland Legislative Session. The Task Force members were named by Governor Paris Glendening in July 2002. The content of this report is intended to be a pre-cursor to a state-wide seminar of the name to be developed by the University of Maryland School of Public Affairs. The seminar is scheduled for Spring of 2003 after the close of the Maryland Legislative Session. The report discusses three innovative concepts that can be used to fund public school construction: 1) Construct/Leaseback, 2) Local Incremental Sales Tax Option for Schools, and 3) Innovative Partnerships. In some cases, these methods, or something similar, are currently being used outside Maryland. The author provides examples where applicable.*

The State of Maryland has clearly demonstrated its commitment to supporting its education infrastructure. Over the last three decades, the State of Maryland has spent \$3.69 billion on public school facilities<sup>1</sup>. In the last five years, the state provided an average of over \$210 million in capital annually to local school districts for construction.<sup>2</sup> With the enrollment peak for high school students not anticipated until 2006 coupled with the need to equip older schools to meet adequacy requirements, the needs for school construction are expected to continue. Meeting these needs in the midst of a nation-wide economic downturn presents a challenge.

This challenge is not a new one and Maryland is not alone in facing it. In fact, many states were forced to develop alternatives to conventional financing methods years ago in response to both revenue shortfalls and voter-initiated constraints on local borrowing. As a result, there are a number of unconventional funding methods which may be of use to Maryland. The author and collaborators have identified three of these concepts and have improved or adapted them where necessary to improve applicability to Maryland conditions.

## CONSTRUCT-LEASEBACK

Construct-Leaseback is a form of public-private partnership which allows counties to work with the private sector to build new schools without issuing bonds or requiring State contribution. In many areas,

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<sup>1</sup> *Background Material: Public School Construction Program.* Presented to the Task Force to Study Public School Facilities on August 12, 2002.

<sup>2</sup> In this document, the term “construction” refers to both the construction of new facilities and the renovation or modernization of existing facilities. In general, it is meant to capture any activity included in the Capital Improvement Program for public K-12 schools.

local governments look to new housing development to pay for additional capacity in public infrastructure through the use of impact fees, excise taxes or land exactments<sup>3</sup>. While some of this money is earmarked to fund new school construction, revenues generated are often not sufficient to fund building the necessary capacity needed to house the associated increase in student enrollment. The additional funding required is raised through the issue of general obligation (GO) bonds, the use of current operating revenues, state funding or a combination thereof.

Using the construct-leaseback method, developers could build the necessary schools to house increased enrollment in lieu of impact fees, land exactments or excise taxes. Unlike current lease-purchase and sale-leaseback methods, ownership of the school building and the land on which it sits would be the property of the developers and would not transfer to the local school system at the end of the lease<sup>4</sup>. Schools systems would lease the building from the developer under a long-term contract, say 50 years, but could exercise opt-out clauses after a specified period of time, say 20 years. The lease, paid through the operating budget would cover debt service and a pre-set profit margin.<sup>5</sup>

An additional benefit of the construct-leaseback method is that it reduces the risk of school systems building unnecessary long-term capacity. This is especially relevant for Maryland as school enrollment is nearing an expected peak in 2005 and is expected to drop by 4% in the following six years.<sup>6</sup> The forecasted drop in enrollment stemming from population shifts and the aging of once growing communities leads to excess school capacity. Schools built to have a 50-year life are built in response to enrollment which could shift in 20 years or less. The construct-leaseback method effectively shifts this demographic risk to developers who are better equipped to handle it.

Similarly, the construct-leaseback method gives school systems more flexibility to respond to new thinking on optimal learning spaces. With rapidly advancing technology, it is difficult to imagine what schools may need to look like in the future. School systems may not want to conform to traditional design for schools and classrooms but may be constrained due to the design and capabilities of existing physical structures. By leasing facilities, school systems can effectively transfer this obsolescence risk to the developers as well.

Lastly, the cost sharing arrangement between the State and local school systems also provides an incentive for use of construct-leaseback arrangements. Currently, the State and the local school system share in eligible construction costs with the State contributing approximately 28% of total spending.<sup>7</sup> If, however, the project costs exceed projections, the overrun is entirely borne by the school district. On the other hand, any cost savings accrue to the State reducing its contribution. This dynamic makes increases in project costs especially expensive for local school districts. However, if the district uses construct-

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<sup>3</sup> See accompanying report titled *Local Funding Strategies for School Construction: An Analysis of Six Maryland Counties* for a detailed discussion of development-related revenues.

<sup>4</sup> Current lease-purchase and sale-leaseback contracts used in public school construction typically include provisions which allow the school system to purchase the facility at the end of the lease term for a nominal fee.

<sup>5</sup> In the "Innovative Partnerships" section of this report, examples are provided of public-private collaborations where savings to the school systems are built-in by setting lease payments at less than 100% of financing costs.

<sup>6</sup> *School Enrollment and School Crowding in Maryland*. Maryland Department of Planning. Presented to the Task Force to Study Public School Facilities in August 2002.

<sup>7</sup> Based on a 10-year average of State funding vs. a 10-year average of total funding of school construction based on FY1991-2000 data published in *Selected Financial Data, Part 1 - Revenue, Wealth and Effort* by the Maryland State Department of Education.

leaseback financing coupled with a cost performance provision, the risk of cost overruns is shifted to the developer.

This provides many benefits to the public, the local school system and to the private developer. First, this allows the school system to have the capacity available when the additional students move-in. Because of current lead times in the school construction process, the construction of additional school capacity financed by developer impact fees and excise taxes is not complete, or sometimes even begun, when the new students arrive leading to school overcrowding and the use of temporary classrooms. Second, as the school system can opt-out of the lease after a specified period of time, it allows flexibility to deal with anticipated peaks and subsequent valleys in student enrollment. This shifts enrollment and demographic risk to the developer. Third, as the school would be built by the developer as part of the overall construction process, developers can guarantee potential home buyers a new school in the development would be built at a specific time. Currently, even with land exactments and fees, developers cannot give potential home buyers a guaranteed timeframe under which a new school would be built. Lastly, as the building and property would continue to be owned by the developer, the building and associated land could be put to the developer's best use once the lease ends.

There are also several ways the construct-leaseback method could be enhanced by spreading the investment risk thereby reducing required returns (lease costs). The developer could choose to construct the school under a stand-alone, project-specific not-for-profit corporation. This would allow the not-for-profit corporation to raise funding to build the schools using tax-exempt bonds thereby lowering related interest costs. In other states, developers have reduced their risk by issuing certificates of participation or by issuing lease purchase revenue bonds.

There are many details which need to be determined on how to best execute this method of increasing new school capacity. These include answering questions around responsibility for on-going operation and maintenance of the school facility, construction standards to which developers would need to adhere, etc. However, the ability of local schools systems to bring new school capacity on-line in time to meet the needs of children moving into a community, and to do so without issuing local government bond while maintaining the ability to shift demographic and cost risk to the developer would be a significant improvement to the status-quo.

In an extreme example of this concept, Portland Public Schools is getting out of the facilities business altogether. After two years of public meetings and commissioned studies, the district developed a Best Use of Facilities Report which later became the basis for its 2002 Long Range Plan developed by a local non-profit. Through this work, Portland discovered its educational funding was being used to subsidize its inefficient facilities. As a result, the school district decided to reduce its facilities inventory via sales or leasing. Additionally, the district founded the Portland Schools Real Estate Trust. The Trust is an independent non-profit which will serve as the district's real estate arm. Initially, the Trust is expected to assist the district in negotiating leases, sales and purchases of property. Longer term, the Trust could serve as the manager and owner of the school system's real estate.

The Trust has three objectives:

1. To generate annual net revenue for the district,
2. To help the district meet its goal of flexible property management, and
3. To allow the district to focus its energies on its core mission, education, instead of “technical and community issues related to real estate.”<sup>8</sup>

While it is too early to tell whether Portland’s strategy will be successful, this model provides a look at one district’s use of long-term leasing as a means of creating the flexibility it needs to respond to enrollment shifts and to changing facilities requirements.

### **LOCAL INCREMENTAL SALES TAX OPTION FOR SCHOOLS (LISTOS)**

The Local Incremental Sales Tax Option for Schools (LISTOS) is enabling legislation the State could pass which would allow local jurisdictions to levy a  $\frac{1}{2}\text{¢}$  or  $1\text{¢}$  in incremental sales taxes specifically for public school construction. Further, the State could allow local jurisdictions to implement LISTOS in a way which allows the most implementation flexibility, such as not requiring voter referendum or waiver of county-imposed revenue caps. Additionally, by identifying a dedicated stream of funding, districts using LISTOS as an alternative to issuing GO bonds would save on interest and issuance costs.

Each participating county’s incremental funds raised using LISTOS would be divided into two parts. Two-thirds would be for the county to use on its public school construction and renovation program. The other third would go into a fund made up of contributions from all counties participating in the LISTOS program. Funds would then be allocated based on need to participating school systems which lack the fiscal capacity to fund school construction through the existing combination of state and local means.

Local option sales taxes are not a new idea. Currently, several states including New York, Pennsylvania, Florida, Georgia and Texas, allow counties, cities and /or school districts to increase sales taxes for school funding.<sup>9</sup> In Georgia, for example, Atlanta school districts expect to raise close to \$2 billion from local option sales taxes generated in the surrounding counties.<sup>10</sup> However, in many areas local option sales taxes are not an effective means to raise capital funds in smaller, poorer jurisdictions because they do not have the sales base to support capital-intensive school construction projects. LISTOS is different in that the smaller, poorer jurisdictions have an incentive to enact the increase in sales taxes because of the availability of the pooled funds.

LISTOS is an exciting option for several reasons. First, it is an option the State can implement without requiring additional State funding. Second, it gives local jurisdictions committed to enhancing or enlarging schools the tools they need to raise money to invest in their infrastructure. Finally, by implementing a pooled sharing of a portion of the LISTOS-raised resources, counties with varied populations and wealth bases are able to benefit from the program.

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<sup>8</sup> DeArmond, Michael ; Sara Tagart and Paul Hill. *The Future of School Facilities: Getting Ahead of the Curve*. May 2002.

<sup>9</sup> Local Option Sales Taxes, A Legisbrief. *Fiscal Affairs*. August/September 1998. Vol. 6 No. 34. National Conference of State Legislators.

<sup>10</sup> Reid, Karla Scoon. “Voters in Atlanta-Area Districts Extend Tax for Schools.” *Education Week*. March 27, 2002. Vol. 21 Issue 28, p.5.

## **INNOVATIVE PARTNERSHIPS – COMMERCIAL DEVELOPMENT AND SHARED USE**

There are a number of ways innovative partnerships can be used to build school infrastructure or to leverage existing infrastructure in ways that free up capital for school construction. For example:

- Air-rights over existing school facilities in commercially developed areas can be leased to private entities.
- Historical tax credits associated with the renovation of older schools may be marketed to private investors if a commercial use is incorporated into the school concept. Eligibility for federal and state preservation tax credits for these unique partnerships would have to be verified by the Internal Revenue Service.
- Shared-use facilities which can leverage scarce local capital funds to build complementary facilities. For example, in Avalon, New Jersey, local leaders are proposing to opt-out of the county library system and use the related savings to meet debt service on bonds used to expand an elementary school to include both dedicated subject space and a new community library.
- Extension of current use of performance contracting to finance construction of new facilities.

### **The James F. Oyster Bilingual School**

Perhaps the best known example of the way public-private partnerships can be used creatively to build schools is the Oyster School reconstruction in Washington, D.C.<sup>11</sup> Sitting on a 1.67 acres in the Woodley Park neighborhood, the James F. Oyster Elementary School was poised for closure. In the early 1990s, the District of Columbia Public Schools (DCPS) did not have a master plan for school infrastructure improvements nor the capital to fund one. The school, which was known for its dual-immersion program in Spanish and English, was overcrowded and deteriorating. There was insufficient classroom space for instruction and there was no space for the school's special education, physical education, arts and science programs. The school was not accessible to disabled students, teachers or parents.

Through a partnership with the DCPS and LCOR, Incorporated, a national real-estate firm specializing in public/private development, the community got a new school at no cost to taxpayers. DCPS agreed to deed over one half of the site to LCOR for commercial residential development in exchange for LCOR's construction of the new school.

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<sup>11</sup> Richard, Alan. "Developer, D.C. District Team Up to Build New Elementary School" *Education Week*. September 5, 2001.

The new Oyster School sits on a smaller 0.79 acre site but has an enlarged building with enhanced features:

	<i>Old Building</i>	<i>New Building</i>
Enrollment	300 students	350 students
Building size	26,591 sq. ft.	47,984 sq. ft..
Average classroom size	725 sq. ft.	900 sq. ft.
Library/Media center	900 sq. ft.	2,100 sq. ft.
Multipurpose room	2,400 sq. ft.	3,750 sq. ft.
Gymnasium	None	3,700 sq. ft.
Art room	900 sq. ft.	1,200 sq. ft.
Music room	None	950 sq. ft.
Parking	14 surface spaces	33 underground spaces
Outdoor play area	18,000 sq. ft.	8,000 sq. ft.

Source: *Building Outside the Box /Public-private partnership: A strategy for improved public school buildings*. 21<sup>st</sup> Century School Fund

To pay for the reconstruction, the District of Columbia raised \$11 million in 35-year tax-exempt revenue bonds. The \$804,000 annual debt service will be paid from property taxes and revenue generated by the 211 unit apartment building built by LCOR on the rest of the site.<sup>12</sup> Clearly this type of collaboration requires a special set of circumstances, however, in many urban areas of Maryland with high property values but limited funding capacity, this could hold promise.

## Nova Scotia

Facing ongoing economic hardship and a freeze on its capital budget since 1990, Nova Scotia enacted legislation facilitating public-private partnerships for school construction in 1997. By 1998, eight schools were built, 30 school projects were approved and 12 school projects were in the development phase. The province requested bids from qualified bidders to build schools according to Nova Scotia's specifications. The schools would be turnkey operations with the developers providing desks, blackboards, telephones and computers.

The school system leases the buildings from the developers for 20 years, however, building use covers school hours only (Monday through Friday, September through June, 8:30am to 3:30pm). More importantly, the school system's lease payments are only 85% of the capitalized cost of the building. The developer leases the building to other approved entities during non-school hours to make up the difference in cost and generate profit. This provides the developer an incentive to build cost-effectively as lower building costs reduce financing costs. At the same time, the developer must design and build competitive facilities in order to attract the necessary non-school lessees. Finally, as the school system is not required to purchase the building at the end of the lease (though it has an option to do so), it is in the developer's best interest to maintain and upgrade the building in order to maintain marketability.<sup>13</sup>

<sup>12</sup> *Building Outside the Box, Public-Private Partnership: A Strategy for Improved Public School Buildings*. 21<sup>st</sup> Century School Fund.

<sup>13</sup> Utt, PhD., Ronald D. "How Public-Private Partnerships can Facilitate Public School Construction" *The Heritage Foundation Backgrounder*. February 23, 1999. No. 1257.

### Public-Private Partnerships – What’s the Next Step?

There are a growing number of examples where public-private partnerships have been used to finance school construction projects for cash-strapped districts. However, the related policy question is of more significance to this report. How can the creativity present in private sector partnerships be harnessed to address the State’s school construction needs? How can public-private partnerships be facilitated? Virginia’s Public Private Education and Infrastructure Act (PPEA) attempts to do this.

PPEA was recently enacted in Virginia’s 2002 legislative session. It was modeled after the 1995 Public Private Transportation Act which is credited with the development of large, complex and costly road projects which were not deemed possible via traditional financing methods. PPEA allows private parties to develop public projects under the approval of the responsible public entity. Additionally, qualified projects are exempted from Virginia’s Public Procurement Act which, among other things, requires contracts be awarded to the lowest bidder.

A project may qualify for PPEA treatment if:

- (i) there is a public need for or benefit derived from the qualifying project of the type proposed by the private entity;
- (ii) the estimated cost of the qualifying project is reasonable in relation to similar facilities;
- (iii) the private entity's plans will result in the timely acquisition, design, construction, improvement, renovation, expansion, equipping, maintenance, or operation of the qualifying project.

The Task Force is scheduled to hear Virginia Delegate Preston Bryant discuss PPEA in detail at the November 22<sup>nd</sup> meeting. In advance of that meeting, this report recommends the attached framework for analyzing public-private partnership in the Maryland context.

Lisa Rawlings, Faculty Research Assistant at the University of Maryland School of Public Affairs, would like to acknowledge the contribution of Jacqueline Rogers and Marita Brown, both of whom are Senior Research Faculty at the Maryland School of Public Affairs, without whose assistance this research would not have been impossible. The contributors may be contacted at the numbers and email addresses below:

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**ATTACHMENT**

**Public-Private Partnerships - A Framework for Analysis**

The concept of public-private partnerships (PPPs) has come to incorporate a number of ideas. In order to understand its relevance for Maryland, PPP must be broken down into its component parts. Specifically, it is important to isolate savings or efficiencies stemming from the use of lease financing, from exemptions from public procurement regulations and from other provisions of PPPs. In preparation for Delegate Bryant’s presentation, the author suggests the following as way to look at PPPs. Further details are forthcoming in a separate report by the author.

The following table provides a framework for evaluating PPPs in the Maryland context:

<b>Benefits Unique to Public Private Partnerships</b>	<b>Benefits Attributed to Public Private Partnerships which are not Unique</b>
<ul style="list-style-type: none"> <li>▪ Depreciation tax savings accrue to non-government entity which can benefit</li> <li>▪ Cost overrun risk can be shifted from counties to developer</li> <li>▪ Demographic risk can be shifted from counties to developer</li> <li>▪ Incentives to design-in savings and generate revenues can be built in</li> <li>▪ Non-traditional use of public school space during non-school time</li> <li>▪ Non-traditional locations of school buildings</li> <li>▪ Use of performance contracting</li> </ul>	<ul style="list-style-type: none"> <li>▪ Interest savings from shorter maturities used for leasing contracts</li> <li>▪ Time and money savings from foregoing voter referendum for bond issue<sup>14</sup></li> <li>▪ Time and money savings from circumventing existing procurement regulations</li> <li>▪ State support of public school construction via contribution of lease payments</li> </ul>
<b>Costs Unique to Public Private Partnerships</b>	<b>Costs Attributed to Public Private Partnerships which are not Unique</b>
<ul style="list-style-type: none"> <li>▪ Increased issue costs for certificates of participation and lease revenue bonds vs. general obligation bonds</li> <li>▪ Increase interest costs due to non-appropriation clause in lease contracts</li> </ul>	<ul style="list-style-type: none"> <li>▪ Profit margins of developers are not different, in principal, from private sector returns from any public contract. Net benefit/cost to taxpayer is relevant.</li> </ul>

<sup>14</sup> In Maryland, bond issues for school construction do not usually require voter approval.