Citizens Finance Review Commission

Report on Financing School Capital Construction

Prepared for the Citizens Finance Review Commission

by

Authors:

James Bush, Partner at Fennemore Craig PC
Timothy Hogan, Executive Director, Arizona Center for Law in the Public Interest
Martin Shultz, Vice President Government Affairs for Pinnacle West Capital Corporation
Stephen Newmark, Partner at Brown & Bain PA

This paper is the result of the collaborative efforts of many people. This paper is not, however, representative of the views of all of the authors. To attribute any author with the various positions taken in this paper would be misleading. Rather, the authors attempted to disclose as fully and succinctly as possible the various different opinions and literature on any given topic to aid the CFRC in its deliberations.

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I. BACKGROUND

Historically, the capital needs of Arizona schools were handled at the local school district level. School districts sold general obligation bonds that had to be approved by the voters. The bonds were paid for by property taxes assessed against property in the school district.

In July 1994, the Arizona State Supreme Court held in *Roosevelt v. Bishop* that the state's statutory scheme for financing capital construction for public schools violated article XI, §1 of the Arizona Constitution. ("The Legislature shall enact such laws as shall provide for the establishment and maintenance of a general and uniform public school system. . . .") The court held that the existing school financing system did not comply with the general and uniform requirement because its heavy reliance on local property taxation, combined with arbitrary school district boundaries and lack of meaningful equalization, directly caused substantial capital disparities among school districts.

Several unsuccessful attempts by the legislature to fix the problem led to additional Arizona State Supreme Court decisions. In one such decision, *Hull v. Albrecht*, the Supreme Court established a two-pronged test for assessing whether a school financing system meets the state constitutional requirements: (1) the state must establish minimum adequate facility standards and provide funding to ensure that no district falls below them, and (2) the funding mechanism chosen by the state must not itself cause substantial disparities among districts.

In 1998, the Arizona State Legislators enacted Students FIRST legislation that was signed into law and found adequate by the State Supreme Court as not violating the Arizona Constitution. Students FIRST established a centralized school capital funding system with limited bonding for the school districts, building adequacy standards, a mechanism for curing existing deficiencies, a building renewal formula and a new construction funding formula.

The centralized school capital funding system, relieved the school districts of the requirement of funding capital needs of the school districts and placed the burden onto the State general fund. The districts were still authorized to issue voter approved general obligation bonds paid for by property tax; however, those bond monies would only be needed if the district wanted to make capital improvements above and beyond the minimum amount paid for by the state general fund.

Stated differently, Students FIRST eliminated the traditional revenue stream that had been used to pay for capital construction, that is, local property tax, and placed the expense associated with that revenue stream, that is, the capital needs of schools, onto the general fund. Some have observed that four years of an additional $300 million burden to the general fund, along with the downturn in the economy and pressures to increase expenditures has led to the current structural deficit. Thus, to put the general fund back to where it was before Students FIRST, the general fund needs a replacement revenue stream to fund capital needs of schools.

Financing Arizona's school construction program using bonding is a capital budgeting decision on a parallel with capital investment decisions made in the private sector on a daily basis. Private firms compare the discounted net revenues that accrue from private investment decisions with the cost of the financial capital required to fund any project. Decisions to pursue projects are based upon a simple comparison of the costs and net benefits of alternatives.

Failure to employ the capital markets in this fashion would leave the private sector with a sub optimal number of completed projects – resulting in an under utilization of resources. Indeed, economies with poorly functioning capital markets languish while those with access to efficient, freely functioning capital markets flourish.

The principle of efficient capital budgeting applies to school finance even though schools do not yield net revenues as do private sector physical plants or production lines. But the basic principle applies. School districts need to make building decisions that are based upon access to the capital markets. A newly constructed school can yield direct benefits (analogous to net revenues in the private sector) to students over the life of the school and indirect benefits to society that span generations. While it is difficult to translate the benefits of new schools into dollars, they most certainly exist or new schools should not be built at all – rendering the debt financing or current funding considerations mute. Debt financing is appropriate because the benefits of school construction extend beyond the year in which the school is constructed. (Indeed few, if any, benefits to education accrue during the school construction year itself) Financing the school over its lifetime is an efficient way of matching benefits to costs in the same manner that private sector firms match future net revenues to continuing debt service.

The Arizona "student's first initiative" created a pool of General Fund money that may be used for the construction of a fixed number of schools or construction projects. Indeed, if only a small number of projects need to be pursued in each year, then government might use this pool to build only a small number of schools each year and avoid financing costs. However, such a strategy would likely result in an inefficient amount (too much or too little) of school construction – limited by a pay as you go strategy or bloated by the tendency for government agencies to "spend their designated pools of funds". The parallel in the private sector is to examine the large multi-national firm with a large pool of operating cash available at any one time. Quite simply, do large multi-nationals always choose to avoid financing costs they might incur in the capital markets and finance projects only out of "cash on hand?" Clearly this is not the case. Governments, like private sector firms, need to match the benefits of construction and capital improvements with the costs of providing those improvements over the estimated life of the school to attain the efficient amount of school construction. Quite simply, establish the need for school construction based on the benefits of the construction and then debt finance the construction.

In the end, the benefits of new school construction must be matched with the costs of new school construction over the life of the school, just like the benefits of private sector projects must meet or exceed financing costs over the life of the project. This position is not a license to build and over abundance of schools, the principle of capital budgeting simply encourages use of efficient capital markets to finance the construction of schools.

II. PROPOSALS

A. Students FIRST Financing Proposals

Under Students FIRST, school facility construction costs to the state are approximately $300 million per year including renewal costs. The proposal is to debt finance the full amount and pay for the debt service with a dedicated property tax revenue stream. The property tax would be assessed as a secondary property tax in one of 2 ways:

1) Statewide property tax or

2) County school construction assessment, similar to the County equalization assessment.

Another component to this proposal is to put additional limits on school districts in their ability to go above and beyond the minimum adequacy standards. There is some concern that within the existing limits there is still potential to allow for too much disparity among districts.

Finally, as it is generally agreed upon that the property tax on businesses in Arizona is high compared to the rest of the country, it is important that this proposal not exacerbate the problem. So, this report recommends that any additional property tax not be adopted unless reforms are made to the existing property tax system. In particular, this report proposes that the assessment ratio differential between homeowners and businesses be significantly reduced for not only the new property tax being proposed by this report, but also for all new voter approved secondary property taxes. Furthermore, this proposal recommends moving toward a single assessment ratio for primary property taxes as well.

B. Alternatives to Students FIRST Proposals

An alternative proposal would be to repeal Students FIRST and pay for school facility construction costs at a local level. This would be done in one of 2 ways:

1) **Guaranteed Yield Proposal** - The first alternative proposal would be to pay for school facility construction at the local level using debt financing and local property tax to pay the debt service. This proposal requires using a

guaranteed yield formula to ensure that local property tax results in fully equitable access to funding. Under this proposal, the state would create a system whereby a certain amount of local property tax will guarantee a certain yield to that district regardless of the value within the district. A dollar of property tax should result in X dollars per student within that district regardless of the property value within the district. The state can determine mathematically what a dollar of property tax should optimally yield, and those districts that do not get this optimal yield will be subsidized by the state and those districts that get more than the optimal yield will pay into a state fund. The property tax levied by the school district would be a primary property tax.

The proposal would require that the state maintain some oversight to ensure minimum adequacy standards are met. The state would establish a formula based on minimum adequacy standards that determines when a school district must build and maintain certain capital facilities. If the trigger is met, then the school district must levy a tax at the local level to fund the requirements established in the formula. The state would also require that it must pre-approve certain capital construction plans and maintenance programs before the school district can levy the funds to ensure minimum adequacy standards are being met.

The proposal would allow school district to go above and beyond minimum adequacy standards, but there must be a public vote. And to avoid the potential for substantial disparities between districts, there must be additional limits to what is allowed above and beyond.

2) **Capital QTR Proposal** - The second alternative proposal would be to create a capital facility construction funding formula and a capital qualifying tax rate that would be administered similarly to the way the current maintenance and operations expenses are funded. Under this proposal, the local school district would determine the amount of money needed by the district to pay for school facilities based on a formula. The formula would be based on student count, square footage, and other factors. Then the school district would assess a local property tax of no more than the capital qualifying tax rate (capital QTR). The capital QTR would be set at the state level. Then the state would provide equalization assistance to those districts whose need exceeded what the levy would yield by the capital QTR tax rate.

   Unincorporated school districts and high wealth school districts would be assessed by the state a minimum capital QTR such that all property would be assessed at least 100% of the capital QTR.

Just as in the Students FIRST financing proposals, in order for these alternatives to not exacerbate an already high business property tax, this report recommends that any additional property tax not be adopted unless reforms are made to the existing property tax system. The reforms proposed are the same as stated above under the Students FIRST financing proposals.

III. ADMINISTRATION OF PROPOSAL

A. Students FIRST Financing Proposals

Assessing property tax at the state or county level is relatively easy. The county already assesses a property tax. So the rate would merely increase. If the state assessed the tax, the state could have the county collect a statewide property tax in addition to the property tax already collected by the county.

Implementation of a statewide property tax would require a 2/3rds vote of the legislature. Arizona Constitution, Article 9, §22.

Implementation of a county school construction assessment would only require a majority vote of the legislature so long as the money collected by the county goes directly to the schools and does not flow through the general fund.

Debt financing using a statewide property tax requires a vote of the people on two issues. First, debt secured by property tax requires raising the constitutional statewide debt limit. Article 9, §5 limits the states' debt to $350 thousand. In order to debt finance $300 million per year over a 20 year period requires that the debt limit be raised to at least $6 billion. Assuming inflation and other factors, the debt limit should probably be raised even more.

In addition, the constitution requires a public vote in order to issue general obligation bonds backed by property tax.

Debt financing at the county level also requires a public vote on two issues. First, the constitutional local debt limit must be changed. Arizona Constitution, Article 9, §8. And, issuing general obligation bonds backed by property tax requires a public vote.

Changing the property tax assessment ratios is addressed in other reports.

B. Alternatives to Students FIRST Proposals

Assessing property tax at a local level is relatively easy to administer. School districts already assess local property tax. These proposals merely result in a change in the rate.

Constitutional debt limits and related statutes might have to be altered to the extent school districts are at their debt limit and then need to issue additional debt to build schools.

Determining the guaranteed yield formula for the first alternative would require significant analysis, but once determined it should be relatively easy to administer.

Similarly, determining an appropriate capital facilities construction funding formula would require significant analysis. However, once determined, it should be relatively easy to administer.

IV. IMPACT ON EXISTING REVENUE SYSTEMS

All of the proposals propose new property tax based revenue streams that are unrelated to any existing revenue streams. So long as the debt limits are expanded appropriately, these proposals should have minimal impact on any existing revenue systems.

V. POLICY CONSIDERATIONS

A. Equity

All of the proposals provide some level of vertical equity. Property tax is inherently progressive. From the individual perspective, taxpayers with more valuable property assets pay a higher tax. Although not always the case, generally, individuals with more valuable property can afford to pay a higher tax. Property tax becomes problematic during times of disproportionately high property value inflation, such as what occurred in California during the 1980's and 1990's. Under those circumstances, because property values rise much faster than income, individuals can be forced to sell their property to pay the tax.

Similarly with respect to businesses, generally, businesses with more valuable property can afford to pay higher tax.

Horizontal equity is somewhat more problematic. In Arizona, a $100,000 business is taxed at a rate 2 and 1/2 times what a $100,000 home is taxed. To the extent that any of the proposals are adopted without first ameliorating this inherent inequity in the property tax system, the proposals simply exacerbate the problem. One advantage of using the secondary property tax over the primary property tax is that neither the homeowner rebate nor the 1% constitutional cap on residential property tax is applicable.

The two alternative proposals to Students FIRST require additional consideration. In both the guaranteed yield proposal and the capital QTR proposal, some effort was made to ensure that property owners in high wealth districts were not taxed more than property owners in low wealth districts. In both proposals there still remains some discrepancy between high property wealth districts and low property wealth districts. For example, to allow for more local control, districts are allowed in a limited way to go above and beyond what is provided for in the guaranteed yield formula. In the capital

QTR proposal, certain districts may only pay 50% of the capital QTR while most districts will pay 100% of the QTR. Thus, in neither of these plans is complete horizontal equity achieved.

B. Economic Vitality

Taxes, in general, negatively impact economic growth. The goal is to minimize the negative impact. One way to achieve this goal is to ensure that Arizona's tax structure is competitive with other states that Arizona competes.

Arizona's property tax on residences is 38th in the country. Unfortunately, Arizona's property tax on businesses is third highest in the country. Thus, the state has some room to increase property taxes on residences while still maintaining a relatively low rate, but has no room to increase property tax on businesses. In fact, the property tax on business is already at a level that is detrimental to economic vitality. Thus, any increases in property tax on businesses will exacerbate an already troublesome tax.

This is why none of the proposals should be implemented without rectifying the business property tax problem. Moving toward a single assessment ratio for all new property taxes and for primary property taxes is necessary in order to make any new property tax proposals viable.

C. Volatility

Property tax is the most predictable and the least cyclical when compared to sales tax and corporate and individual income tax. Thus, none of these proposals would create a more volatile tax system.

In the two alternatives to Students FIRST, there are formulas that need to be determined. Both the guaranteed yield formula and the capital facilities construction formula would determine how much impact either of these proposals would have on the general fund. As both of these formulas would be somewhat difficult to determine, their impact to the general fund may be somewhat volatile until the formulae have been sufficiently fine-tuned.

D. Simplicity

1. Students FIRST Financing Proposals

From the taxpayer and the tax collector perspective, both of these proposals are relatively simple. They require increases in property tax rates and are administered under existing systems and paid for by taxpayers already paying the tax.

2. Alternatives to Students FIRST Proposals

Collecting and paying property tax is relatively simple from the taxpayer and tax collector perspective. Furthermore, after the formulae have been established, determining the tax rate should not be too difficult provided the formulae are simple. However, as stated earlier, determining the guaranteed yield formula and determining the capital facilities construction funding formula will not be simple.

VI. ECONOMIC IMPACT

1. Students FIRST Financing Proposals

Both proposals require debt financing approximately $300 million per year for approximately 20 years. A chart attached (Exhibit 1) shows the required revenue stream using the following assumptions: 1) same interest rate every year debt is issued (5%); 2) same amount of debt issued per year ($300 million); 3) 20 year bonds; and 4) equal payments made every year until the debt is paid off. Under this scenario after 12 years, debt service is greater than $300 million. After 20 years, debt service stabilizes at approximately $480 million per year, with the total debt being $6 billion.

Without considering changes in the assessment ratio, the secondary net assessed value statewide in 2002 was $36.8 billion. The tax rate needed to fund the example revenue stream shown in the attached chart would be $.07 in year one escalating to $1.31 in year 20. See Exhibit 2 attached.

A discussion of how moving toward a single assessment ratio changes property tax assessments is found in other reports.

2. Alternatives to Students FIRST Proposals

The economic impact of either of the alternative to Students FIRST cannot be determined until the formulae for the alternatives are established. Then, the impact would be different in each school district.