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THE NEED FOR DEBT POLICY IN MICHIGAN PUBLIC SCHOOLS

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Introduction

School construction is booming across Michigan. Districts in need of more classroom space and updated facilities are undertaking projects in record numbers and dollar amounts. Evidence of this is the recent level of state-guaranteed debt for local K-12 school construction projects, which rose from $2.5 billion to $6.3 billion between 1990 and 1996.[1] This statewide need for school construction mirrors a national trend: Estimates show that a backlog of $112 billion in school repairs and construction exists across the United States.[2] As they have in the past, Michigan's public schools will look to general obligation bonds to provide funds needed for facility construction and renovation. Now more than ever, it is important that schools develop clear policies for the issuance of bonds.

Voter approval is required for schools to issue bonds, and bond elections in Michigan are often contentious. Seldom do bonds pass by overwhelming majorities; as often as not they fail. There are several possible explanations for this. One is that there may be voter resistance due to already high levels of taxation. Another is that local demographics may pit parents of school-aged children against older "empty-nesters" and retirees on fixed incomes. Or the proposed bond amount may just be too much for a majority of electors. Some voters may, for various reasons, be dissatisfied with their local schools or public education in general. There may be organized opposition, and a certain percentage of voters may never be won over to support the bond issue.

Many school officials view their failure to win bond elections as the result of an inadequate public relations effort.[3] They feel that enrollment projections or the poor condition of school facilities should be enough to convince the voters—if only they were better informed. There may indeed be a genuine need for school construction and the bond money to finance it. But beyond that, "voter education" and good PR should not be the primary basis for gaining voter approval for the issuance of debt. Bond elections should rather be won as a result of a school's reputation for responsibility in conducting its affairs and handling its finances.

Many units of government show their responsibility by committing to capital planning and budgeting on a long-term, ongoing basis, and not just when they need to place a bond before the voters. A key management tool for this is the capital improvement program. This program forecasts future demands, schedules major renovations and repairs, anticipates finances, and plans capital acquisitions. It also forecasts future annual operation and maintenance costs associated with new improvements.[4] An integral part of the capital improvement program is the debt policy.[5]

A debt policy is a formal document governing when, how, for what purposes, and to what extent debt may be issued. A sound debt policy offers many benefits to schools that want to better manage their capital improvement programs. Debt policy

- helps schools avoid common pitfalls of debt issuance and management;
- promotes long-term financial stability;
- sends a message of responsibility to taxpayers;
- can help schools earn better bond ratings from rating agencies;
- enhances regulatory compliance; and
- assures that borrowing is done at the lowest cost to taxpayers.

These areas all represent opportunities for improvement in Michigan's public schools. Some districts have been criticized over these issues and cannot afford to ignore problems in debt issuance and management. Maintaining trust with voters is imperative at a time when support for the concept of public education seems to be waning. Public schools are ultimately accountable to voters and must therefore seize every opportunity to earn and keep their confidence.

School district leaders who wish to build that trust and confidence can solve many debt management problems locally by implementing policies like those presented in this paper. Other problems have statewide significance and there is much that state-level policy makers can do through debt policy to improve the long-term financial health of Michigan public education.

Current Problems in School Bonding

The municipal bond industry as a whole generally enjoys a sound reputation of trust and value to investors and of service to issuers. Even so, industry observers note some problem areas: local government defaults; near-defaults and bankruptcies; payoffs and kickbacks to local officials; "pay to play" campaign contribution schemes; high risk investments involving "derivatives"; "yield burning," or profiteering by securities dealers; conflict of interest; lack of disclosure; exorbitant fees; and excessive reliance on negotiated deals.[6]

Public school bonding in Michigan has problems of its own. These include the following:

- school electioneering;
- School Bond Loan Fund borrowing;
- excessive debt levies and bond fund surpluses;
- capitalization of expenses;
- lack of competition in school bonding; and
- conflict of interest in debt issuance.

Each of these areas is discussed in greater detail below. Some of the points raised here represent opinion and may be subject to debate, but to dismiss the concerns raised by these issues would be a disservice to taxpayers, parents, schools, and the students themselves.

School Electioneering

Units of government may not engage in electioneering—the spending of tax dollars or the use of public resources, either directly or indirectly, to influence elections.[7] This is a legal and ethical fact that Michigan's Attorney General has repeated on several occasions.[8]

In spite of this, some Michigan schools have reportedly used school telephones, computers, mailing lists, facilities, on-duty personnel, and even children in the classroom to "get out the yes vote" in bond or millage elections. Some schools even appear to have used or been solicited by private consultants for "election assistance" services to help in winning their bond elections.

Bond proposals should stand on their own merits without any direct or indirect government promotion. Responsible governments leave it to private groups, civic organizations, or ballot committees to run election campaigns. Certainly governments may provide objective, unbiased information regarding their bond proposals, but there should be a distinct line between voter education and covert electioneering and the astute administrator knows when it is crossed.

Public schools have a duty to uphold a posture of neutrality toward their elections, particularly since they themselves are in charge of running the elections. Purity of elections is a cornerstone of democracy, and when schools cut corners on this process, they risk undercutting the broad community support necessary for their success.

School Bond Loan Fund Borrowing

The School Bond Loan Fund (SBLF) is a Michigan state bonding program established in 1955 ostensibly to help schools "build necessary facilities when they are needed."[9] It lets schools borrow from the state the difference between what their debt levy produces and the amount actually needed to make their annual bond payments.[10] The idea was to allow growing schools to bond for more construction than their existing tax base could reasonably support. The assumption underlying SBLF loans is that the borrowing district's tax base will grow over time, and that eventually the loans can be paid off, on top of the district's bonds.

Originally, a school had to levy at least thirteen mills to tap into the SBLF, but in 1964 the threshold was lowered to seven mills, making it easier for schools to borrow from the Fund. Borrowing districts must levy at least seven mills until their SBLF loans are fully repaid. A district's bond proposal must also be "prequalified" by the Michigan Department of Treasury to be eligible. Qualified bonds are backed by the state's full faith and credit, which results in lower interest rates. However, construction financed by qualified bonds is subject to Michigan's Prevailing Wage law, which requires (for all practical purposes) that union-scale wages be paid for construction labor.[11] Michigan's SBLF program appears to be unique in the nation.[12]

The SBLF is analogous to an annual cash advance to help make home mortgage payments. Interest is effectively paid on interest, and the total cost of borrowing is increased accordingly—sometimes by millions of dollars in the case of some SBLF borrowers. Consequently, some districts are projected to make repayments for decades and others are projected not to be able to repay the Fund at all.[13] The financial liabilities inherent in such a scheme should be obvious, but the SBLF's basic premise of borrowing to repay borrowing has remained largely unquestioned for over four decades.

SBLF borrowing appeals to some districts because it helps them get bond proposals passed while avoiding unpopular tax increases. It does this by reducing the relative tax burden on current taxpayers and shifting it onto future taxpayers.

But there are significant drawbacks. An SBLF-funded bond is like a variable rate balloon mortgage of unknown total cost and duration. It can add excessive interest cost and is highly sensitive to future increases in interest rates. Its effect in terms of interest is similar to capital appreciation bonds (CABs)— a type of delayed-repayment bond—which were outlawed under Proposal A of 1994 due to their exorbitant interest cost.[14] A bond funded by SBLF borrowing gambles on continuous growth of tax base and continually favorable interest rates well into the future. It locks future taxpayers into higher tax rates than would otherwise be necessary, sapping their ability to build facilities when *they* need them.

Some in Michigan's education community are now publicly admitting that some schools will have difficulty meeting required SBLF repayments.[15] Schools that are serious about incurring debt at the least possible cost should be very cautious about borrowing from the School Bond Loan Fund.

Excessive Debt Levies and Bond Fund Surpluses

When voters approve a bond proposal, they approve the sale of a certain amount of bonds. They do not approve a debt millage rate. After voter approval, the government issuing the bonds has the power to tax "without limitation as to rate or amount" for the repayment of the bonds.[16] This constitutional clause assures bondholders that they will be repaid. The actual debt levy (SBLF borrowing notwithstanding) is calculated by dividing the total payment of principal and interest to be made in a given year by the local unit's taxable valuation—that is, its total tax base. A nominal amount may be added to cover delinquent taxes. By law schools must set their debt millage at whatever rate is "sufficient" to make annual principal and interest payments on their bonds.[17] Excessive or surplus funds should not accumulate in bond repayment accounts.

Nonetheless, some Michigan schools have levied excessive debt taxes and accumulated surplus funds.[18] Instead of annually calculating a debt levy which is merely "sufficient" to meet annual bond payments, they have held their debt levy constant over a period of several years. As their tax base grew, they were able to add hundreds of thousands of dollars to their bond repayment accounts. In the cases where this has occurred, it appears to have been part of an election strategy to avoid a bond millage increase after the anticipated passage of a bond proposal. Ostensibly, the bond is more appealing to the voters if it can be claimed that their taxes will not increase if it is approved.

This "debt service over-levy" strategy may be effective in winning bond elections, but it is ill-advised and unauthorized by law. School districts should calculate their debt millage each year and levy the minimum amount necessary to make their debt service payments.

Capitalization of Expenses and Technology and Equipment Bonds

School bonds were traditionally used for "bricks and mortar," that is, new construction. But over the years, the purposes of school bonding have been expanded. Today, schools can bond for "furnishing and refurnishing," "equipping and re-equipping," remodeling and partial remodeling, buses, computers, and even software.[19] In other words, schools may now bond for numerous things which used to be paid for out of their annual operating budgets.

This trend may be traced to the fact that capital outlays for many schools' annual operating budgets are inadequate for meeting essential maintenance, repair, and equipment needs. Because of ever-rising labor costs and operating expenses, some schools have found it expedient to "shift" costs formerly considered expenses onto bonds.

While much of this shift has occurred legally, some of it has not. Some Michigan schools have improperly used the proceeds of qualified bonds to purchase all manner of loose supplies, equipment, textbooks, software, and other highly depreciable items. Acting upon complaints, the Michigan Department of Treasury has in the past required offending schools to reimburse their bond funds with tens of thousands of dollars from their operating funds.[20]

Proposal A sought to address this issue by introducing certain common-sense requirements, but these requirements unfortunately have been easily evaded. For example, bonds cannot be issued for a term longer than the useful life of an asset.[21] Accordingly, schools issuing bonds for "technology" or computers along with a building project may front-load their repayment schedules to pay off the computers. But instead of making concurrent payments on the building project, some schools delay building payments until after the computers are paid off.[22] The net effect is that more interest is paid than if repayments were made on both computers and buildings from the start. The intent of Proposal A's new provision (that is, good fiscal practice) is thereby skirted.

Similarly, bond proceeds may not be used for facility maintenance.[23] Under the acquisition policies of many agencies, normal reroofing, repaving, repainting, recarpeting, and other work of a recurring nature and relatively limited life are classified as maintenance. But they are considered as remodeling under Michigan's bond laws, and are eligible for bonding repayment periods of up to 30 years.

The lax attitude in some schools about the use of bond proceeds must be corrected. Whether legal or not, this "capitalization of expenses" is a bad habit.[24] It was at the root of many public fiscal disasters, most notably the financial crisis of New York City in the 1970's. Michigan's public schools should not be put at risk through such poor fiscal habits.

Lack of Competition in School Bonding

There has been an excessive reliance on negotiated, or noncompetitive, issuance of school debt in Michigan in the recent past. The reasons for this include the wave of bond refinancings in the early 1990s, excessive use of CABs, and other factors. Fortunately, school bonding has become more competitive since the passage of Proposal A, but the majority of negotiated school bond deals in Michigan are still handled by only two broker/dealers, and the lion's share of bond-related professional services goes to one bond counsel and one financial advisor. Clearly more can be done to increase competition in school bonding.

The potential benefits of increased competition include reduced debt, improved professional services, and overall savings to taxpayers. A sound debt policy could insure that bonds are issued competitively whenever possible, and that professional services are obtained openly and fairly, through formal qualifications-based selection.

Conflict of Interest in Debt Issuance

Public officials and their employees, agents, and consultants should not gain undue private benefits as a result of their official actions. They should stay clear of positions where they may gain such benefits or which compromise their ability to provide independent advice—advice that is in the best interest of the public they serve. This principle is the essence of avoiding conflict of interest. Most of those involved in public administration are very mindful of it.

In some Michigan schools, however, there have been lapses. When conflict of interest occurs in school bonding, the consequences can be serious, as one recent legal malpractice lawsuit in Michigan shows.[25] Schools can never be too cautious about the issuance of debt. A formal debt policy with firm guidelines can help in avoiding the pitfalls of conflict of interest.

Establishment of a Debt Policy

An effective debt policy should be firm but not onerous, flexible but not loose. Elements should include the purposes for which debt may or may not be used, the limitations of debt, and the standards for debt issuance. Many municipalities and local governments have adopted formal debt policies, and there are a number of resources available to school districts seeking to prepare their own.[26] The input of school bond counsel and financial advisors can also be helpful in this regard.

Following is a list of suggested debt policy elements; most are not original, but are rather derived from current literature, existing policies, and other sources. Some elements are presented to suggest possible remedies to the problems outlined above; others are merely common sense. However, there is no one "model policy," since the needs and circumstances of each school district are unique.

Michigan schools should take an honest, serious look at their past bonding practices and identify any areas that may be improved. An effective debt policy can help. School bonding is an area of public policy where there are opportunities to make significant improvements—improvements that can have real and lasting benefits. Michigan's schools should seize those opportunities.

Elements of a Sound Debt Policy

1. Long-term debt will not be used to finance current operations or to capitalize expenses. The school district will avoid the use of long-term debt to finance facility maintenance, repairs, recurring equipment purchases, and other items traditionally funded in the annual operating budget.

The capitalization of expenses—that is, the shifting of operational costs, facility maintenance, and repair onto long-term debt—is a classic pitfall of government finance. The practice should be expressly prohibited.

2. Long-term debt will be used only for capital projects that cannot be financed from current revenue sources. Where acquisitions are financed by issuing bonds, the bonds will be paid off in a period not to exceed the expected life of the acquisition, using IRS depreciation schedules as a guideline.

This policy ensures that current funds, if available, will be used for capital projects before long-term debt is used. It also ensures payments will not continue to be made on acquisitions after their useful life has expired.

3. Total indebtedness of the school district will not exceed fifteen percent of the taxable valuation of the school district for any given year.

The legal debt limitation is fifteen percent,[27] though it should be noted that qualified school bonds are exempt from this limit under Michigan law. Qualified school bonds are general obligations of the school district, while they are budgetary (sometimes called "moral") obligations of the state in the event of default. It is arguable as a matter of local district policy and of honesty to taxpayers and bond buyers that qualified bonds be included in the fifteen-percent limitation. This fifteen-percent limitation is a maximum; however, fiscal prudence and the financial situation of the district may warrant a lesser percentage.

4. The school district will retire fifty percent of the total principal outstanding for general obligation debt within ten years of the date of issuance.

This policy encourages repayment of debt in the shortest possible time without creating undue hardship for the taxpayers.[28]

5. The school district will use only level or declining debt repayment schedules; it will not use back-loaded or ballooning repayment schedules or variable-rate debt. When a bond issue for a capital project includes the purchase of technology, equipment, or other items having a shorter life expectancy than the capital project, then debt repayments for the capital project will not be deferred but rather made on a

level or declining repayment schedule. The school district will avoid borrowing from the School Bond Loan Fund.

Level or declining repayment schedules incur less interest cost. Delayed repayment schedules, typically used in an over-optimistic expectation of strong long-term growth of tax base, incur greater interest cost. Delayed or back-loaded repayment schedules also lock future taxpayers into unnecessarily high debt repayment taxes. Variable-rate debt, dependent upon external rates and indices, is arguably a form of speculation.

6. The school district will not issue refunding (refinancing) bonds for the purpose of interest rate savings unless net present value savings exceed three percent of the par value of the proposed new bonds.

Three to five percent is the range for typical savings thresholds.

7. The school district will avoid the use of capital leases, certificates of participation, or similar instruments for the acquisition or use of facilities or equipment.

Capital leases (also called certificates of participation) are a form of lease obligation whereby a government enters into a lease agreement with a third party. The third party then uses the lease payments as security for obligations ("certificates" or conduit securities) that it issues for the acquisition of the facility or equipment to be leased. The government makes lease payments as a first budgetary obligation and no additional tax is imposed to secure the obligation. Therefore voter approval is unnecessary. But avoidance of voter approval creates suspicion, which is the main source of controversy for capital leases. Also, the government may vacate the lease through non-appropriation, and although capital leases are not considered "debt," such termination of the lease can have a serious impact on the government's creditworthiness.[29]

8. The instruments of investment of capital funds will be limited to the following:

- *U. S. Treasury securities;*
- *obligations of specific agencies of the federal government;*
- *fully insured or collateralized certificates of deposit at commercial banks and savings and loans associations;*
- *money market mutual funds whose portfolio consists of government securities;*
- *local government pools or trusts; or*
- *repurchase agreements collateralized by U.S. Treasury securities.*

This policy ensures security of capital funds. Note that the 1994 financial disaster of Orange County, California, involving investments in derivatives could easily have been averted through a sound investment policy.[30]

9. Debt will be issued through the competitive bidding process except as expressly approved by resolution of the school board. If it is proposed that debt not be issued through competitive bidding, the resolution will state the compelling reasons why the competitive bidding process is not deemed suitable for the particular issuance of debt.

Competitive bidding can reduce interest costs. It avoids questions of unfairness and favoritism in the debt underwriter selection process. General obligation school bonds are typically not so complex, and marketing or timing considerations not so critical, as to warrant anything but competitive bidding for most bond issues.

10. The school district is committed to the principles of full and continuing disclosure and will comply with all applicable U. S. Security and Exchange Commission (SEC) rules, Government Finance Officers Association guidelines, and National Federation of Municipal Analysts recommendations pertaining to disclosure. The school district will use Generally Accepted Accounting Principles in the preparation of all financial statements used in complying with disclosure requirements, and will submit annual financial information to securities information repositories as required. All financial statements pertaining to debt issuance will be audited annually by an independent, certified public accounting firm. All financial information and other data pertaining to debt issuance will be provided only by the school board or its authorized representative.

Under SEC regulations, full and continuing disclosure is mandatory for issuers of debt. An explicit policy statement stresses its importance to the issuer.

11. Consultants providing advice or counsel for any issuance of school district debt and broker/dealers acquiring school district debt shall be independent. The financial advisor, bond counsel, and broker/dealer for any issuance of debt shall each be separate entities having no relationship to one another.

This policy prevents conflict of interest and incorporates and exceeds the requirements of Municipal Securities Rulemaking Board Rule G-23 (which permits financial advisor/underwriter relationships if such relationships are disclosed to the issuer).

12. Any financial advisor to the school district also capable of providing underwriting services shall be prohibited from participating in the underwriting of any debt in the school district for a period of two years from the date of termination of his contract for financial advisory services.

This policy prevents "role-switching" and insures that the financial advisor, having no interest in underwriting the debt, will be able to provide independent financial advice.

13. The financial advisor and bond counsel shall provide full and continuing disclosure to the school district of any relationship or agreement, formal or informal, that may be in conflict with the best interest of the school district. The financial advisor and bond counsel shall further be prohibited from engaging in such relationships or agreements without the express prior consent of the school board. The financial advisor and bond counsel shall certify in writing their compliance with this policy.

The potential for conflict of interest, where it may exist, should be expressly recognized by bond consultants.

14. Selection of consultants for the providing of professional services for any bond issue will be based upon qualification, through formal requests for proposals. Procurement of services related to the issuance of bonds, including selection of paying agent, bond registrar, escrow agent, bond printer, official statement printer, and trustee will be through competitive bidding whenever possible.[31]

The process for securing bond-related services should be open, fair, and objective, as it should be for all public procurement.

15. Public funds, property, and resources will not be used, directly or indirectly, to influence the outcome of ballot questions. No financial consultant, bond counsel, underwriter, broker/dealer, or other person or business involved or potentially involved with the issuance of debt in the school district shall provide contributions to ballot committees involved in school district bond elections, nor shall they provide contributions to any person able to recommend their services.

Financial consultants, bond counsel, underwriters, broker/dealers, and design consultants should be expected to uphold a position of neutrality with respect to the outcome of bond elections, as should the school district itself. Bond professionals and others should be barred from "pay to play" practices—that is, making political contributions to those involved in the issuance of public debt.[32]

Conclusion

School bonding can be a complex and obscure subject. Few taxpayers, and indeed few school officials, understand it in much detail. Because schools tend to be infrequent issuers of bonds, few (if any) have formal and comprehensive debt policies.

Even so, Michigan public schools are now issuing debt for capital projects at an unprecedented pace. This intensive need for school construction and repairs is occurring in a time of budget constraints and tax resistance in many districts.

Problems and abuses have arisen in this climate. These problems, several of which have been discussed here, may themselves seem complex and obscure, but they are real. And they can be serious and potentially costly, both in terms of wasted resources and voter trust. Michigan's public schools owe it to parents, taxpayers, and students to issue and manage debt with the utmost responsibility. That responsibility can start with debt policy.

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15. Richard Wilson, Executive Director, School Equity Caucus, quoted in Gongwer News Service, Inc.'s *Michigan Report*, August 30, 1996, p. 2.

16. Constitution of the State of Michigan of 1963, Article IX, Section 16.

17. MCL 137.1a.

18. Ref. *Howell Public Schools Debt Retirement Fund Statements from Audited Financial Reports, FY Ended June 30, 1991 through 1995,* for an illustrative example.

19. MCL 380.1351a.(1).

20. For example, see Matthew Bach, "How Did This Happen?" *Livingston County Press*, December 25, 1996, p. 12A and *id.*, "State Questioning Past Bond Issues in Pinckney," *Livingston County Press*, December 11, 1996, p. 1A.

21. MCL 380.1351a.(3).

22. Ref. *Byron Area Schools Application for Preliminary Qualification of Bonds, July 10, 1995,* and also *Howell Public Schools Application for Preliminary Qualification of Bonds, November 24, 1997,* for illustrative examples.

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