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Stop Climbing Debt Mountain: A new approach to financing school facilities

Recommendation

Amend Texas Education Code (Chapter 44) so that school districts can contract with Real Estate Investment Trusts (REITs) for the construction of public education facilities. School districts should also be permitted to enter into long-term contracts with REITs for the asset management, capital improvement, and maintenance of their existing facilities. These long-term contracts must stipulate that school districts retain exclusive use of the facilities during hours when they offer classes or otherwise require the facilities for school-related activities.

REITs would derive their primary income from maintenance and operations contracts, thereby allowing private financing to shift much of the burden of school facilities funding away from the state. This recommendation applies the intent of House Bill 2803 (79R) by Representative Morrison to public education facilities across the state. H.B.2803 would have authorized junior colleges and higher education institutions to enter into contracts with REITs for the construction, maintenance and development of their facilities.

Background: A Burden on the State

The Houston Chronicle (November 27, 2006) reported that several lawmakers have already identified that education facilities funding will be an important issue during the 80th Legislature. According to the report, “several billion dollars are needed for school buildings across Texas. Pointing out that “we don’t project out what our needs are...we

just go a year at a time,” Senate Education Committee Chairman Florence Shapiro (R-Plano) has made it clear that long-term planning of school facilities funding is required.¹

In order to ensure the long-term sustainability of Texas’ education facilities, significant steps need to be taken to improve the ways in which school buildings, campuses, and other school district properties are funded.

An important part of education spending is the investment that is made in school facilities across the state. School districts in Texas have typically financed the purchase of these assets through debt financing (i.e. the sale of school bonds). This approach, however, relies on the public debt market, requires significant subsidization by the state as a result, and puts additional pressure on local property taxes to fund debt payments.²

The Permanent School Fund

The state subsidizes the sale of school bonds primarily through the Permanent School Fund (PSF). According to the 2005 Annual Report of the Texas Permanent School Fund:

“As of fiscal year end, the Fund has guaranteed \$35.2 billion in school district bond issues to public education support in Texas. This represents an increase from the previous fiscal year of 9.8% in the total of guaranteed bond issues outstanding.”³

The PSF exists as a state guarantee so that school districts can qualify for the most favorable bond ratings. With a PSF guarantee, school district bonds carry a low degree of investment risk; interest payments are protected, and the principal is secure. However, the burden of guaranteeing more than 2,200 school bond issues places a significant strain on the PSF. According to a report published by the Comptroller in October 2006, between 1992 and 2006, bond issues guaranteed by the PSF have increased by 1087%.⁴

Through House Bill 1295 by Representative Hochberg, the 78th Legislature increased the debt that the PSF was permitted to guarantee from twice the value of the fund, to two and half times the value of the fund. In March 2006, the State Auditor’s Office estimated that this new limit would be reached in “two or three year’s time,” while the Texas Education Agency reported that the limit would be reached in FY 2009.⁵

In addition to guaranteeing school district bonds through the PSF, the state subsidizes the debt service payments on these bonds through the Instructional Facilities Allotment program (IFA) and the Existing Debt Allotment program (EDA). Another program, the New Instructional Facilities Allotment program (NIFA), provides state aid to offset the

¹ “Schools Still Big Issue at Capitol,” *The Houston Chronicle*, November 27, 2006.

² “Debt for School Facilities: Trends and Issues,” House Research Organization, January 16, 2003.

³ FY 2005 Annual Report of the Texas Permanent School Fund, page 11.

⁴ “Current and Future Facilities Needs of Texas Public School Districts,” Office of the Texas Comptroller, October 2006; <http://www.window.state.tx.us/specialrpt/facilities2006/>

⁵ “Current and Future Facilities Needs of Texas Public School Districts,” Office of the Texas Comptroller, October 2006; <http://www.window.state.tx.us/specialrpt/facilities2006/>

start-up costs of new campuses during the first two years of operation. Each of these programs is administered by the state, at a cost to taxpayers. In the 2006-07 biennium, \$1.59 billion was appropriated to extend funding to the EDA, IFA, and NIFA programs. The Texas Education Agency's (TEA) 2008-09 budget request includes \$1.5 billion to meet current obligations under the EDA, IFA, and NIFA programs, as well as an additional \$330 million to roll the EDA program forward and provide new IFA grants.⁶

With the PSF likely to reach its newly-established limit before the 81st Legislature convenes, finding a meaningful, long-term solution to school district facilities funding during the 80th Legislature is imperative. However, effective and long-lasting reform of the way in which school facilities are funded should not require the appropriation of additional state revenue, which has gone too far with the creation of NIFA. There are market-based solutions that should be put in place instead of imposing an additional burden on state revenue and taxpayers.

Shifting the Burden from the State

While school districts have typically financed the construction, development, and maintenance of their facilities through the issuance of public debt, the private sector makes use of both the debt and equity markets in order to raise capital. Because taxpayers have borne the burden of the cost of developing school district facilities, the equity retained in school district facilities – which is an enormous public asset – has remained untapped.

The state should seek to access this equity by allowing Real Estate Investment Trusts (REITs) to help school districts finance the both cost of constructing new facilities and the cost of maintaining and developing their existing facilities. REITs were created by Congress in 1960 in order to allow small investors to invest in large-scale real estate. By pooling the resources of a number of investors, REITs use the capital of many investors to acquire properties. Instead of earning dividends derived from owning stock in corporations, REIT investors accrue the economic benefits that derive from real estate ownership.⁷

In practice, school districts would be able to contract with a REIT for the construction of new facilities. School districts would also be able to contract with a REIT for the maintenance, operation, and development of their existing facilities (such as school buildings, administrative buildings, school bus maintenance facilities etc.). To be clear, school districts would not transfer the ownership of their existing facilities to a REIT, rather, they would enter into long-term contracts (20-30 years) for the use of the facilities for educational purposes, and for the asset management, capital improvement, and maintenance of the facilities. REITs would derive their income from the contracts they enter into with school districts. If a school district requires larger buildings or otherwise improved facilities on an existing site, the construction would be undertaken by the REIT, which would ultimately benefit from operating larger facilities.

⁶ Legislative Budget Board Summary of Public Education Facilities, October 2006.

⁷ Bill Analysis of H.B. 2803 (79R).

The use of REITs to finance construction and maintenance of higher education facilities in Texas and other states is relatively common. The largest student housing REIT in the nation is American Campus Communities (ACC), which has developed facilities for Texas A&M University, Sam Houston State University, Texas State University, the University of North Texas, and Lamar University. ACC has also developed higher education facilities in twenty other states.⁸ At the end of 2005, ACC owned more than \$550 million worth of assets, in addition to which, it manages and/or leases a further 53 properties nationwide.⁹ The success of REITs such as ACC should serve as the model for the introduction of private investment into the public school arena.

The use of private real estate investment to facilitate the development and maintenance of public buildings is also common at the federal level, and in other countries, such as Canada, New Zealand, and Australia. In the United States, the case of New York's World Trade Center is a particularly significant example of a private investor leasing property from a public body. The World Trade Center is owned by the Port Authority of New York and New Jersey, and was leased to the private property management and development company Silverstein Properties Inc. in a 99-year, \$3.21 billion deal in May 2001.¹⁰ Since the September 11, 2001 terrorist attacks, Silverstein Properties has begun to rebuild the destroyed office space. The reconstruction of 7 World Trade Center was completed by Silverstein in May 2006, and it is the "first commercial tower to be certified as "green" because it uses less electricity and high-efficiency heating and cooling systems...it has adopted newer safety standards, with wider stairwells and 2-foot thick concrete walls."¹¹ This type of innovation in building construction would clearly be advantageous for any type of public or private facility; Texas public schools should be no exception.

Looking at other examples of private investment involvement with public buildings, the Canadian federal government began to outsource the management and maintenance of government buildings in the early 1990s through Public Works and Government Services Canada (PWGSC). PWGSC announced in 2005 that it is considering outsourcing the ownership of US\$2.85 billion worth of government facilities to Real Estate Investment Trusts. According to PWGSC Minister Scott Brison, US\$800 million would be saved from the department's US\$1.90 billion annual real estate management budget over five years if ownership was transferred to REITs.¹² Brison also announced that PWGSC would consult government institutions in Australia, New Zealand, and Great Britain which have examined or implemented the sale of public buildings to the private sector.¹³

⁸ ACC Current Property Search; <http://www.studenthousing.com/portfolio/results.asp> [accessed 12/20/06]

⁹ "American Campus Communities Creates Quality Housing for Higher Education," *National Association of Real Estate Investment Trusts*, July/August 2006.

¹⁰ "Silverstein Wins 99-Year WTC Net Lease," *Real Estate Weekly*, May 2, 2001.

¹¹ "In NYC, Hope Scrapes the Sky," *CBS News Online*, May 23, 2006.

¹² "Ottawa Studies Selloff of Federal Buildings," *Ontario Business News*, July 21, 2005; <http://www.businessedge.ca/article.cfm/newsID/10089.cfm>

¹³ "Minister Brison Invites Bids to Study Future of Government Buildings," *PWGSC News*, September 6, 2005.

At the federal level in the United States, private real estate investment in public buildings is overseen by the General Services Administration (GSA), which was created in 1949 by the Federal Property Administrative Services Act. The GSA established the Public Buildings Service (PBS) to carry out real estate activity on its behalf.

In fiscal year 2006, PBS is involved in new construction projects totaling \$792 million, including a Coast Guard facility in Washington D.C., Border Stations in Calais, ME, Blaine, WA, Massena, NY, and Jackson, ME, as well as a federal office building in Tuscaloosa, AL, and an FDA facility in Maryland. PBS also finances the maintenance of the public buildings it operates, the cost of which totals \$861 million in fiscal year 2006. A few of the large repair and alteration projects financed by PBS in 2006 are in Texas: most notably, a \$500,000 project involving the Post Office and U.S Courthouse in San Antonio, and a \$2.2 million project to maintain the Leland Federal Building in Houston.¹⁴

The GSA reports that the Public Buildings Service operates more than 342 million square feet of office space across the nation, half of which is comprised of 1,500 government-owned buildings. The remaining buildings are privately owned leased facilities.¹⁵

The U.S. Office of Management and Budget, which evaluates federal programs, found that in fiscal year 2005:

“The PBS new construction program achieved its program goals within budgeted costs...[and] achieved the performance goals for LEED [Leadership in Energy and Environmental Design] certification and achievement of operational requirements.”¹⁶

This performance standard is in stark contrast to the results attained by school districts in Texas. *The Dallas Morning News* (November 4, 2006) reported that administrators at Garland Independent School District (GISD) “earmarked \$5.1 million in 2002 to renovate and expand Southgate Elementary School and Kimberlin Academy for Excellence. The bill came in 43% percent higher, at \$7.3 million.”¹⁷ According to the report, cost overruns on current projects in the district total \$6.4 million. Similarly, on November 24, *The Fort Worth Star-Telegram* reported that in Kennedale Independent School District, “the \$40 million school bond program that voters approved in May 2004 has expanded in scope.” The expansion includes a \$1.65 million athletics facility. Kennedale Superintendent, Gary Dugger, arguing in favor of the additions to the bond program points out that “we felt that anything we build would eventually be used. We thought that it was better to expand now while everything was in place.”¹⁸

¹⁴ Presentation by Charles Matta, Office of Chief Architect, GSA; www.nibs.org/FEDCON/gsa.pdf

¹⁵ General Services Administration; <http://www.gsa.gov>

¹⁶ ExpectMore.gov, detailed information on the General Services Administration – New Construction Assessment; <http://www.whitehouse.gov/omb/expectmore/detail.10002420.2005.html>

¹⁷ “Inflation a Threat to Building Plans,” *The Dallas Morning News*, November 4, 2006.

¹⁸ “More Facilities Added to Projects,” *The Fort Worth Star-Telegram*, November 24, 2006.

It is this approach to school facilities funding that causes costs to soar in excess of budgeted spending. Adopting a private finance approach to constructing and maintaining school district facilities will ensure that projects are efficiently planned, and that state and local taxpayers are no longer required to foot the bill for poorly planned school facilities development. By utilizing REITs, Texas school districts can ensure that Senator Shapiro's concern that "we don't project out what our needs are," is concretely addressed. Careful planning and strict adherence to budgeted spending will be a prerequisite if private financing through REITs is to be successful.

Low Risk

REITs in Texas own and operate more than \$8 billion worth of property, and are commonly used to finance ownership, development, and maintenance of many different types of property. According to the Federal Reserve Bank of Dallas, "[m]ost Texas REITs own and operate various types of real estate, including office, retail, multifamily, restaurant, and hotel properties."¹⁹ These are low-risk investment ventures, and evidence that the state would not be jeopardizing school facilities or the education of Texas' children by permitting school districts to finance facility construction and maintenance through REITs. Using REITs to assist school district's facility needs will be a particularly low-risk approach because the contracts that school districts enter into must specify that they should retain use of the facilities during hours when they offer classes, or otherwise require the facilities for educational purposes. Under these contracts, REITs would only be permitted to use the facilities for other purposes when they are not required by school districts. The principal objective of adopting a private finance approach is to ensure that school districts can meet the maintenance and development needs of their facilities.

Those who advocate increasing the burden on state and local taxpayers to generate additional funding for school facilities will likely be critical of adopting a private finance approach such as REITs.

However, research by the Federal Reserve Bank of Dallas makes it clear that REITs are a low-risk undertaking that in fact have a stabilizing impact on the real estate market:

"[S]ome observers have argued that during the 2001-02 downturn, REITs helped prevent a return to the overcapacity that plagued the 1980s. As the [real estate] industry matured, improved information flow and transparency helped discourage inordinate construction."²⁰

This discouragement of excessive construction would provide a timely solution to the type of budgeting problems in school districts such as Kennedale.

¹⁹"Have REITs Helped Tame Texas Real Estate?" Southwest Economy, Issue 6, Nov/Dec 2002, Federal Reserve Bank of Dallas.

²⁰ Ibid.

Recommendations

To address the concerns of parties such as Senator Shapiro, and to ensure the long-term sustainability of school facilities funding as the Permanent School Fund nears its limit in terms of the value of bonds it can guarantee, school districts should be permitted to contract with REITs for the maintenance of existing school facilities, as well as for the construction of new facilities. Amending the Education Code (Chapter 44) to achieve this end is recommended.

REITs would be able to raise private equity capital to invest in the construction and maintenance of educational facilities across the state. By entering into performance-based management contracts, school districts would be guaranteed the best possible maintenance and development of their facilities. Additionally, the state would benefit because the burden of school district facility construction, maintenance, and development, which is currently born by the Permanent School Fund and other financing programs, would be significantly reduced.

Conclusion

Facilities funding should no longer rest on a rising mountain of debt, but be turned into an opportunity to unlock the value of existing assets and create new value for the system of public education. Financing the construction, management, and maintenance of existing school facilities, as well as the construction of new facilities through REITs will produce significant savings to state and local taxpayers. By shifting financing to the private sector, school districts will be able to construct new facilities without having to raise additional tax revenues, while they will also benefit from improved and more efficient management of their existing facilities.