THE Center for Education Reform

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SOLVING THE CHARTER SCHOOL FINANCING CONUNDRUM

Charter schools are an important component of education reform. Unfortunately, charter schools often have difficulty obtaining capital financing and the funds needed to cover initial operating expenses and other start-up costs. This one of the most challenging obstacles that charter schools face, but state legislators can make it easier. They can advance education reform by implementing favorable charter school financing policies. Here are some policies lawmakers should consider implementing in their states to alleviate financing burdens on charter schools.

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Charter schools in many states rely heavily on grants from a federally authorized fund called the *Public Charter Schools Program*. Often in these states, this federal grant money is the only source of start-up funding available to charter schools. This should not be the case. There are several policy options available to the states that can provide the funding and the flexibility necessary to foster new charter schools. Some of these policy strategies are outlined by the Charter Friends National Network 1999 publication, *Paying for the Charter Schoolhouse* (www.charterfriends.org).

Four Ways to Improve Charter School Finance

1. **Provide alternative sources of cash flow, other than per pupil spending, to be used expressly for the purposes of capital and start-up costs**.

   This payment can be based on projected attendance and should be scheduled to arrive early enough to cover capital and start-up costs. Legislators must also be sure to equalize per pupil funding between charter and non-charter public schools.

2. **Allow charter schools to take advantage of the same tax-exempt and low-cost financing that is available to more traditional institutions**.

   Typically, school districts finance new facilities and capital needs by selling tax-exempt bonds that are backed by the faith and credit of a local authority, usually the government. State lawmakers can legally define charter schools so that they can take advantage of this financing option. State lawmakers can also provide tax breaks for those who lease facilities to charter schools wherein the benefit is returned to the charter school in the form of lower lease payments.

3. **Encourage the growth and expansion of specialized loan programs and financing pools that lend money to charter schools on favorable terms**.

   Legislators have the power to create loan programs and financing pools. They can appropriate funds from the state budget to these new financing pools, pre-existing financing pools, or loan programs. They should also encourage other investors to contribute to these loan programs and pooled sources of funds.

4. **Consider ways to improve the viability of charter schools as an investment opportunity and find ways to encourage organizations to lend support to the charter school.**

   Investors are leery of charter schools because they are public institutions with low earning potential and futures dependent upon performance. Good charter laws will provide incentives that encourage public and private organizations to work with charter schools. These incentives should include tax breaks for investors.

WHERE THESE SOLUTIONS ARE AT WORK

1. **Sources of Cash Flow**

   Federal and private grants are welcomed but insufficient and charter schools should not rely upon them. To provide sufficient aid, state legislators are amending their charter laws so charters can access state funds to pay for more costly capital and start-up costs. Many states have begun to offer grants and/or increases in per-student allocations that are to be used for such capital expenses as facilities, purchases and renovations or construction. The states that have adopted this strategy are blazing a trail that charter advocates and lawmakers in other states should follow.

   - **Arizona** provides access to grants from a Stimulus Fund that was established in the State Treasury specifically for the use of charter schools. The State Department of Education administers this fund that can be used for start-up costs, as well as for the cost of renovating or remodeling buildings. Qualifying schools may receive an initial grant of up to $100,000 during or before their first year of operation and schools that received an initial grant may apply to receive an additional grant of up to $100,000.[i] Arizona also provides an additional $400 per student to charter schools for both capital and operational funding to help equalize their revenue. In Fall 2000, all public schools will receive an additional $350 per student.

   - In 1999, the **Minnesota** legislature moved to provide additional support for charter schools. Charter schools in their first two years of operation may receive grants in the amount of $50,000 per school or $500 times the number of students served, whichever is greater. The state's Department of Children, Families and Learning must provide the grant within 45 days of the first day of school.

To assist with lease payments, the state provides "lease aid." Charter schools may apply to the state for building lease aid when, one the one hand, they determine that it may economically advantageous to lease a building or land and, on the other, the school's total operating capital revenue is insufficient to cover the lease payments. The program provides to charter schools no less than 90 percent of the cost or $1,200 per student, whichever is smaller. New schools are to receive ten percent of this lease aid by July 15th every year.[ii]

- **Massachusetts** makes competitive grants available to charter schools for planning, developing, and leasing and/or constructing facilities. Charter schools can also apply *Goals 2000* funds and other federal sources of money to cover start-up costs. In 1998-99 school year the state provided an additional one-time appropriation of $270 per student specifically for facilities.[iii]

- **Florida** is one of the few states that incorporates capital and facility expenses into its charter law. Charter schools receive one-fifteenth of the capital cost per pupil allocated by the state for specific grade levels.[iv] Charter schools also receive monies to purchase property, conduct construction or renovations, or to make lease payments through its School Infrastructure Thrift (SIT) Awards. Once a charter school reaches its third year, it may receive monies from the Public Education Capital Outlay (PECO) and Service Trust Fund.[v]

- **Utah** makes grant monies available to charter school for start-up costs at the discretion of the Superintendent of Public Instruction. Once a charter school has secured a facility in the form of a written agreement for the use of space, the Superintendent can then award a one-time grant to the charter school of $62,500.[vi]

- **New York's** 1998 charter law created a Charter School Stimulus Fund to assist schools with start-up and facilities costs, which in 1999, began with $1 million.

- The **District of Columbia** provides $600 per student, which is 60 percent of the District's per pupil capital expenses. Moreover, although it is the responsibility of the District to provide charter schools with preferential bidding rights for vacant public school space, this task has proved daunting.

2. Access to Tax-Exempt/Low-Cost Financing

Perhaps the most efficient and most effective way to help charter schools obtain much needed capital is in providing access to tax-exempt bonds.[1] The sale of tax-exempt bonds helps with the financial needs of schools. The interest payments

[1] A bond is a formal certificate of indebtedness issued by governments or business corporations in return for loans. It bears a fixed rate of interest and promises to repay the funds borrowed after a certain period, usually 10 years or more. Bonds issued by city and state governments are exempt from federal income taxes.

on these bonds are not subject to federal income tax, and, in some cases, state or local income tax, making the project more financially feasible. Two policy approaches of this kind of financing exist: **direct** and **indirect**. State should also consider creating **tax credits** for the landlords of charter schools.

Direct financing allows charter schools to issue bonds on their own behalf, rather than going through a special bond issuer, thereby eliminating transaction costs. In order to utilize direct financing, however, charter schools must attain "public agency" status as defined by the IRS. Traditionally, public agency status requires substantial control by the state. Charter schools are unusual in that they are public agents, but are not controlled by the state. Therein lies a legal ambiguity that lawmakers will need to clarify.[vii]

Indirect financing allows states to create and fund new bonding authorities that can lend to charter schools with tax-exempt status. The authority (such as a local government) sells the bonds for the school and then transfers the proceeds to the school for its capital needs. The school then assumes the debt and must repay it with interest. Again, since the income that the bonds' buyers would earn from the bond is tax-exempt, the bonds can remain attractive to investors, even with a lower interest rate. Lower bond interest rates translate into lower interest payments for the charter schools.

In providing easier access to financing, legislators must be aware if their state is a Dillon Rule state. The Dillon Rule says that unless a public agency is explicitly allowed to take an action, it cannot take such action. This rule could prevent bond authorities from issuing bonds to charter schools, since they are not expressly allowed to do so. To resolve such issues, states legislatures must explicitly authorize bond-issuing authorities to issue bonds on behalf of charter schools as **Colorado**, **North Carolina**, and **Arizona** have done.

- In 1998, **Colorado** expanded the list of eligible beneficiaries of the new Colorado Education and Cultural Facilities Authority. This list now includes organizations with "an educational program pursuant to a charter from a school district." In 1999 Colorado also gave charter schools direct access to bonds at a public rate by defining charters as a "governmental agency." The Colorado Department of Education has also recommended that the legislature provide institutions of higher education specific authority to construct associated charter schools with their capital funds. This recommendation was modeled on the University of North Carolina's Lab School in Greeley, **North Carolina**. The school has been in existence for over 100 years, but only recently converted to charter school status.[viii]

- In 1998, **North Carolina** expanded its Educational Facilities Finance Agency to include non-profit organizations providing K-12 public education. The authority can now sell bonds for charter schools and then transfer the proceeds to the school for its capital needs.

- In **Arizona**, non-profit charter schools may apply for financing from Industrial Development Authorities (IDAs).[ix] IDAs lend the proceeds from a bond sale to qualifying groups that now include public charter schools. In March 2000, Arizona began to demonstrate how such a program would work. The Maricopa County Industrial Development Authority pooled the proceeds of a $27 million bond sale, the first such pool to come to market in the nation. By pooling the financing to accommodate the combined needs of seven charter schools, the Maricopa IDA was able to earn an investment-grade rating of Baa3 on the debt from Moody's Investors Service. Debt proceeds will be distributed to the seven schools, five of which are located within the metropolitan Phoenix area. "The benefit is that they can share the cost of issuance and that they can basically support each other financially at some level," Charles Lotzar, bond counsel with Kutak Rock, told the *Bond Buyer*.[x] According to Yaffa Rattner, a vice president with Moody's, this is important because, "as the charter schools' need to increase their access to the capital market [grows,] financial advisers, underwriters, and bond counsels will need to, in some instances, come up with structures that enhance the credit quality of an individual charter."[xi]

Legislatures should consider providing local government agencies incentives to provide indirect financing to charter schools. The more agencies that are willing to provide indirect financing the more likely it is that charter schools will receive the best rates available and that the ability of the charter schools to make informed decisions will improve.[xii] Competition that drives rates down and produces more information for consumers must always be encouraged.

- For example, in **Colorado**, the Education and Cultural Facility Authority has the authority to issue bonds on behalf of charter schools. They are the only authority that may do so, and this creates high transaction costs in terms in process paperwork and delays. If the legislature provided cities or counties with the authority to issue bonds then the charter schools would be able to choose the most economical and consumer friendly option.

Tax Credits: While these solutions do not entirely solve the facilities crisis of charter schools, used wisely, they can help make a significant dent in the financing burden. Policy makers can also provide a variety of tax incentives that ease the difficulty of obtaining capital financing. For example, charter schools may be exempt from local property taxes. Landlords who lease property to charter schools can obtain this tax exemption and pass the savings onto the schools.

- In **Florida,** charter schools are exempt from ad valorem taxes. The owner of the property is directed to work with the charter school to ensure that the school receives the benefit of the tax break through annual or monthly credits to the school's lease payments.[xiii]

3. Specialized Loan Programs and Financing Pools

Specialized Loan Programs: The creation or expansion of specialized loan programs, specifically for charter schools, would also expand access to low cost financing, thereby providing charter schools with additional funds with lower interest rates. Today, there are two major strategies being employed to create this funding avenue: **individual loans** and **pooled financing**.

Governments or private organizations can create **individual loans** tailored to the charter school's needs. Charter schools can dip into this pool for loans to help bridge their financial gap; and as charter schools become successful and pay off their loans with nominal interest, these programs grow and offer financing opportunities for more charter growth. State and private agencies in **Louisiana**, **New Jersey**, and **Texas** are developing this approach.

- In **Louisiana**, certain classes of charter schools may apply for an interest free loan of up to $100,000 that is payable over three years. Charter schools can use the money for purchases of equipment and other material items that may become the loan's collateral if other collateral has not been secured. Should a charter school default on the loan, the items purchased by the loan are transferred to state ownership.

- The Prudential Foundation's Charter School Lending Program, founded in January 1997, assists thirteen **New Jersey** charter schools cover their start up and early operating costs. Schools qualify by submitting a developed business plan to the foundation that demonstrates the ability to generate revenue and control expenses. Loans are secured and carry at an interest rate of 2.5 percent to five percent, considerably less than market rates. The loan amount is based on school enrollment with a maximum of $1 million and can be used for leasehold improvements and start-up costs rather than major capital expenses such as construction or purchase of facilities. Schools can also receive the loans as many as seven months ahead of the planned opening date with multiple withdrawals, giving the school more flexibility with which to secure start-up needs. By offering this loan with low interest rates, the Foundation helps charter schools establish much needed credit history.[xiv]

- In **Texas**, the Financial Foundation for Texas Charter Schools was established to provide capital funds for the early stages of charter schools. The foundation has already raised $3.27 million for its mission from the Texas banking and business communities. Eighty percent of that is the form of loans and twenty percent in the forms of grants. In 1999, 29 charter schools received loans at six percent (subject to change) for working capital.[xv]

- At the national level, the National Cooperative Bank (NCB) provides financing for improvements, construction expansions, acquisitions, equipment, and for the short-term working capital needs of charter schools through the Bank's nonprofit affiliate, NCB Development Corporation.[xvi] NCB is working in **California**, **Colorado**, the **District of Columbia**, **Minnesota**, **North Carolina**, and **Pennsylvania**, and has six closed loans, with many more committed and pending.

Lawmakers can ease the process of loan acquisition by helping charter schools accumulate the collateral with which to secure loans. For example, legislators can authorize charter schools to own property. They can promote work-placecharter schools like **Florida's** charter school law promotes. The state encourages charter schools to increase business partnerships, reduce school and classroom overcrowding, and transfer the burden of high facility costs to their business partners. They can also require that vacant public space be made available to charter schools at a discount rate. Not only does this provide charters with needed collateral but it also promotes neighborhood development and community investment.

Pooled Financing is a loan program that, as the title implies, gathers money and then lends it to charter schools on favorable terms. The idea is to have non-profit community developers create a fund to which investors, private donors, and public appropriations can contribute. Community developers are then able to lend money from the pool to charter schools that may not be able to strike a deal elsewhere. Since such community developers cannot turn a profit, they administer the loans at a lower interest rate.

- In **North Carolina**, a non-profit program titled Self Help administers the North Carolina Community Facilities Fund, which is used for community and charter school development. Loans of up to $1 million are available with favorable terms such as fixed-rate borrowing for large projects.[xvii]

- The **Chicago** Public School District invested $2 million in a fund maintained by the Illinois Facilities Fund (IFF), a non-profit community developer. The IFF now lends out this money at a modest five percent interest rate.[xviii]

- In **California**, the California Charter School Revolving Loan Fund provides interest free loans of up to $250,000 to help start up charter schools with capital and other needs. The fund is comprised of federal funds obtained by the state for charter schools and any other funds appropriated or transferred to the fund through the annual budget process. As of October 1, 1999 a total of approximately $5.5 million was available for loans from this fund.[xix]

- A twist on the pooling idea is to combine charter schools into larger education entities. The **Colorado League of Charter Schools** is researching this strategy.[xx] Essentially, the idea calls for investors to make funds available to the administering body such as a charter school resource center instead of the individual schools. The schools under the blanket of the administering body then withdraw portions of the funds provided by investors. Those schools that participate can reduce the cost of financing by dividing up any financing fees among them. Spreading loan payments among multiple schools lowers the risk charter schools pose since the probability of multiple charter schools failing or defaulting is smaller that just one. With the lower risk, more investors might be willing to provide funds to the administering body, especially if charter schools flourish.[xxi]

4. Attracting Private Investment

To attract private investment dollars to charter schools, states need to increase incentives for investors and obviate any investor apprehension. As with landlords, states can offer tax credits to investors as an incentive to invest in charter schools. Reduced tax burdens for investors mean more favorable financing rates for charter schools. The federal and state governments commonly use this method to encourage investments in the renovations of historical buildings. Such an approach can reduce the project costs up to 40 percent. Indeed, such benefits can make investing in charter schools more attractive.

- One model tax credit program is the federal **Qualified Zone Academy Bonds**. This program provides a federal income tax credit to lenders who invest in schools that are located in either an "empowerment zone" or in an "enterprise community," or that serve low-income students. States could mimic this tax credit to drive down the cost of financing charter schools.

  Tax credits provide extra incentives for investors, but states will need to do more to increase investor confidence. The risks that charter schools potentially pose to investors are most likely the largest roadblock to adequate access to private funding. Like with any business venture, there are a variety of financing options available to charter schools, but selling a new idea to investors can be difficult. Policy makers must consider ways to improve the charter school's operating environment in order to improve the security of the investment and the confidence of the investors.[2]

- A simple solution is to have states, cities or the federal government guarantee loans to charter schools. By providing the schools with the full faith and credit of the government, investors will regard charter schools as a stable business proposition and be more willing to offer them access to financing.

- Lengthening the period of charter school validity will also help investors warm up to charter schools. Most states set the initial renewal term of the charter up to five years, but some states are expanding that period. In practice, however, a charter has to demonstrate its credibility every year to remain open and enrolled.

  Political obstacles can be a major impediment for charter schools. The degree of the barrier varies from state to state and community to community depending on the area's understanding if charter schools.[3] Protecting charter schools from the politics of revocation and non-renewal is another way to provide stability. The state should advocate clear standards for revocation and create a process to appeal the revocation to protect schools from arbitrary non-renewal. This will assure investors that a school will be not closed down without good cause.[xxii]

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These are only a few of the more popular avenues for policy change that can make it easier for charter schools to gain access to much needed capital financing. These ideas can create a fertile environment in which new charter schools can grow and prosper.

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[2] For more information on the growing education industry see www.EduVentures.com and www.edindustry.com.
[3] For more information on the obstacles charter school often face see *Charter Schools Today: Changing the Face of American Education* (Washington, D.C.: The Center for Education Reform, 2000), pp. 27-59.

For more information on charter school financing, please refer to: the Charter Friends Network "*Paying for the Charter Schoolhouse*" February, 1999 (visit their website at www.charterfriends.org) ; and the Center for Market-Based Education "*School Facilities: Charter School Case Studies*" May 23, 2000 (their website is www.cmbe.org).

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Endnotes:

[i] See A.R.S. 15-188 or R7-2-316 for more details regarding this Stimulus Fund..

[ii] For more details regarding financing in Minnesota's revised charter law see S.F. No. 706 sections 1, 8 and 9 in the Minnesota State Senate or the Omnibus Bill (HF 2333).

[iii] Details regarding the Massachusetts grant program can be found in Chapter 69 of Massachusetts' General Laws, section 1M and Chapter 71 section 89.

[iv] For more information see Florida House Bill 2087 at <www.leg.state/fl.us/session/2000/House/bills/billtext/html/billtext/hb2087e2.html> or visit the Florida Charter School Resource Center at <http://ari.coedu.usf.edu/fcsrc/>. For information on the amount that the state allocates for capital funding, see FL ST § 235.435 (6) (B), funds for comprehensive educational plant needs; construction cost maximums for school.

[v] Florida's Charter law section 228.0561 provides more information regarding capital outlay funding and Section 235.216(2) contains details regarding Florida's School Infrastructure Thrift (SIT) Awards.

[vi] Utah code section 53A-1a-513 section 3 contains the authorization for these start-up grants.

[vii] For example, New York's 1998 charter school law 7881, § 2853 defines the charter entity to be a public agent.

[viii] Russell Caldwell Bigelow and Company and Barry Arrington and Rouse, P.C., *Colorado Charter Schools Capital Finance Study: Challenges and Opportunities for the Future* (Denver: Prepared for the Colorado Department of Education, January 2000), p. 38.

[ix] The Arizona legislature passed House Bill 2103 in June 1999.

[x] Michael B. Marois, "Arizona's Pooled Deal For Schools," *The Bond Buyer*, Vol. 331, No. 30841, Friday, March 3, 2000.

[xi] Id. For more information on Standard and Poor's school evaluation services visit <www.standardandpoors.com/school>

[xii] Russell Caldwell Bigelow and Company and Barry Arrington and Rouse, P.C., *Colorado Charter Schools Capital Finance Study: Challenges and Opportunities for the Future* (Denver: Prepared for the Colorado Department of Education, January 2000), p. 37.

[xiii] For more information see Florida House Bill 2087 at <www.leg.state/fl.us/session/2000/House/bills/billtext/html/billtext/hb2087e2.html> or visit the Florida Charter School Resource Center at <http://ari.coedu.usf.edu/fcsrc/>.

[xiv] For more information see http://www.prudential.com/aboutpru/community/corporate/learn/cmclz1002.htm

[xv] For more information see www.epenergy.com/about/involve.htm, visited September 25, 1999.

[xvi] For more information see http://www.ncb.com/comm_dev.htm, visited September 23, 1999.

[xvii] For more information see http://www.self-help.org/, visited October 1, 1999.

[xviii] For more information see http://npo.net/nponet/alerts/iff.html, visited October 1, 1999.

[xix] For more information on the California Revolving Loan Fund see <www.cde.ca.gov/charter/funding/revloan2.html>, visited March 29, 2000.

[xx] For more information see http://www.coloradoleague.org/, visited October 1, 1999.

[xxi] Russell Caldwell Bigelow and Company and Barry Arrington and Rouse, P.C., *Colorado Charter Schools Capital Finance Study: Challenges and Opportunities for the Future* (Denver: Prepared for the Colorado Department of Education, January 2000), p. 39.

[xxii] See also Russell Caldwell Bigelow and Company and Barry Arrington and Rouse, P.C., *Colorado Charter Schools Capital Finance Study: Challenges and Opportunities for the Future* (Denver: Prepared for the Colorado Department of Education, January 2000), p. 37.