

# **Financing Charter School Facilities in Pennsylvania**

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# Financing Charter School Facilities in Pennsylvania

## I. Challenges of Financing Charter School Facilities

While paying for school facilities has always challenged policymakers, the introduction of charter schools has created an even larger, more complex policy issue. Historically, funding for public school facilities has been a local responsibility, with state funding primarily supporting operational and instructional needs. However, as a result of lawsuits in recent years, states are beginning to take more responsibility for funding school facilities, largely because local districts do not have sufficient funds available to meet their needs, particularly those located in rural and urban areas. State funding of school facilities generally results in a more equitable distribution of resources. At the local level, school districts typically fund their facilities through the sale of general obligation bonds and levy local property taxes to repay these bonds (unless the state helps pay off the debt).

As states consider ways to make their school capital funding systems more equitable, charter schools present both a challenge and an opportunity. Charter schools create challenges since state finance systems were generally designed without charter schools in mind. But they present opportunities as well: addressing the facilities financing problems of charter schools can pave the way to new thinking about how the state funds all of its public school facilities.

In a nutshell, charter schools face two central problems in financing their facilities.

- Having *access to a pool of capital* that allows them to build or renovate a facility; and
- Securing an *ongoing stream of revenue* to pay back the loan or initial capital investment over time (aka debt service in school districts).

As discussed in The Charter Friends National Network's report, *Paying for the Charter Schoolhouse*, these problems arise from a set of challenges that exist in most charter states:

- *The Revenue Challenge:* With few exceptions, charter schools have not had access to either state or local funding for facilities. Instead, charter schools typically make payments on leases or loans out of their operational budgets, leaving less available to commit to instruction.
- *The Tax Status Challenge:* Charter schools are typically not able to take advantage of the low cost financing available to districts through tax-exempt bonding authority.
- *The Risk Challenge:* Lenders, investors, and property owners often regard charter schools as high risk, charging them a premium or refusing to do business with them altogether.

Recently, states have been modifying their charter school policies in order to address these facilities financing issues. This brief will provide examples of these policy modifications. It was prepared by Amy Berk Anderson and Bryan C. Hassel under contract with the Charter Friends National Network, an organization that connects and supports state-level charter school technical assistance activity.\*

The authors collected information and solicited advice for the brief from several national and Pennsylvania-based sources, including: The U.S. Department of Education, The Charter Friends National Network, The Drexel/FOUNDATIONS Technical Assistance Center for Charter Schools, The Reinvestment Fund, The Charter School Project at Duquesne University, The Education Policy and Leadership Center, The Center for Education Reform, The Pennsylvania Public School Building Authority, and others from various state-level charter school associations and state legislatures. Provided within the brief are examples of charter school facilities financing policies and activities across the country organized according to the key issues that Pennsylvania is facing in regards to financing its charter school facilities.

## **II. Charter School Facilities Financing Issues in Pennsylvania**

Some positive efforts are underway in Pennsylvania to address some of the facilities challenges charter schools face. The state has decided to use some of its federal charter school money (approximately \$800 per student) to help new charter schools with start-up costs, including those for facilities. And efforts are underway in Pittsburgh and Philadelphia to create low-interest loan pools, funded by private resources, to finance charter school facilities. Despite these efforts, Pennsylvania, like other states, is struggling with the challenges discussed above. The key issues can be broken down into a handful of areas: (1) Lack of revenue for facilities; (2) Lack of access to tax-exempt financing; (3) Prohibition on the use of operating revenue for new construction; (4) Lender uncertainty about renewal; and (5) Minimal access to high-risk capital.

### **A. Lack of Revenue for Facilities**

Policy Issue: Charter schools in Pennsylvania do not receive state or local revenue for capital outlay.

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Suggested Policy Modification: Create a separate state funding stream to support capital outlay in charter schools and/or include charter schools in the state’s system for funding school facilities.

Discussion of Issue: Nationally, school facilities are funded through state or local sources, or a combination of the two. Some states, such as Florida, attempt to fully fund the building and renovation of school facilities. Others, like Michigan or Virginia, provide no state aid for this purpose. Pennsylvania is an example of a state that shares this responsibility with local school districts by providing some state money for facilities and relying on districts to fund some as well. The funding is equalized, meaning more funding is provided to schools in districts with lower tax bases than those in wealthier communities.

As is the case in many states, charter schools in Pennsylvania are not included in state appropriations for facilities, nor are they included in those at the local level. As a result, charter schools often use a significant portion of their operating budgets for facilities, leaving less for other areas, such as instruction. And as discussed below, PA charter schools cannot use public money for capital outlay. This money may be used only for operational expenses, such as rent and utilities.

Through per pupil allocations or lump sum awards, some jurisdictions are beginning to provide funding for charter school facilities: Arizona, DC, Minnesota, Massachusetts, Florida, Utah, and New York.

- Per Pupil Funding: Several states provide funding to charter schools on a per pupil basis. Minnesota’s Lease Aid program helps charter schools pay their rent by providing no less than 90% of the cost of renting their facility or \$1,500 per student, whichever is smaller. For high school students—who are counted as 1.3 pupil units—this can amount to as much as \$1,900 per student per year. Charter schools in Washington, DC receive over \$600 per pupil annually for facilities costs. Through the School Infrastructure Thrift (SIT) Awards, charter schools in Florida receive funding for purchasing property, construction/renovations, or lease payments and are eligible to receive \$387 per elementary school student and \$587 per high school student in state capital outlay funding to cover ongoing capital expenditures (or debt service). Additionally, as part of a thorough revamping of its school capital finance system in response to a lawsuit, Arizona provides approximately \$400 per student annually to help charter schools with capital expenditures.
- Lump Sum Funding – Some states, including Minnesota (in addition to lease aid), Massachusetts, Utah, and New York provide some form of initial state funding to charter schools for their facilities. These funds are primarily for start-up expenses (including those associated with facilities) and are provided via one-time grants or through a competitive process.

### Considerations:

- Three possible approaches to providing revenue for charter school facilities are: (a) creating a separate stream of state funding for charter school facilities, (b) including charter schools in the state's current system of funding for school facilities by treating charter schools as separate school districts for the purposes of receiving facilities funding; and (c) granting charter schools a per-pupil share of districts' facilities funds.
- Pennsylvania would be providing the same benefits to charter schools as it does other public schools by following any of these three approaches. Since charter schools typically do not receive the local share of moneys for facilities, a state-funded program provides some resources—without which, charter schools would have to rely solely on private fundraising or lenders to support their facility needs.
- Each approach listed above carries its own advantages and challenges. Creating a separate stream of funding for charter school facilities is the simplest approach, but it would require ongoing annual appropriations to maintain. Treating charter schools as separate districts entitled to facilities funding fits nicely with the existing funding system, but it would require complex judgments about how to calculate charter schools' entitlements. Requiring districts to share facilities funds requires no new appropriations, but it would strain relations with districts already short on facilities funding.
- Under the current facilities financing system in Pennsylvania, school districts must go through what can often be a lengthy process of submitting plans to the state for its approval prior to starting construction on a new facility. By folding charter schools into Pennsylvania's state facility financing system, it could potentially mean that charter schools would also have to wait for the state's approval prior to starting any kind of construction. Just as this is often frustrating for school districts, it would also be frustrating for charter schools as they would need a facility for its students and might not have the luxury of using an alternative facility and/or waiting on approval from the state prior to starting construction. In the spirit of deregulation that lies behind charter schools, policymakers should consider ways to ensure these procedural hurdles do not trip up charter schools.
- Policymakers grappled with several other issues when developing policies regarding state funding of charter school facilities—including how much funding to provide, whether to offer annual per-pupil funding or lump-sum payments, and what strings to attach. A comprehensive discussion of these issues is found on pages 8-9 of *Paying for the Charter Schoolhouse*.

## **B. Restricted Access to Tax-Exempt Financing**

**Policy Issue:** The charter school law in Pennsylvania does not include charter schools in the list of entities that are eligible to use a public body to issue bonds on their behalf, nor does the law allow charter schools to issue their own bonds.

**Suggested Policy Modification:** Modify the law to include charter schools in the list of entities that are eligible to use a public body to issue bonds on their behalf and explore the issue of allowing charter schools to issue their own bonds.

**Discussion of Issue:** The primary mechanism that is used to finance school district facilities is through the sale of tax-exempt bonds\*. Proceeds from the sale of these bonds are used to finance school construction and renovation. Interest payments on the bonds are not subject to federal (and sometimes state and local) income tax, resulting in projects that are more affordable.

Nationwide, two ways of granting charter schools access to tax-exempt financing have emerged. The first approach allows charter schools to issue their own bonds by giving charter schools “public agency” status as defined by the IRS. Only public agents are eligible to obtain tax-exempt financing on their own. For example, New York’s 1998 Charter Law (7881 §2853) defines the charter entity to be a public agent, and amendments to Colorado’s statutes in 1999 do the same.

The second approach requires the charter school to go through a designated bonding authority (e.g., cities, counties, or authorities that issue bonds for post-secondary institutions, cultural institutions, housing developments or medical facilities). Only certain activities are eligible for tax-exempt bonds, and these are typically listed in legislation, making it clear to bonding authorities the purposes for which they can and can not issue bonds.

Charter schools are not included in Pennsylvania’s list of public entities that are permitted to use a bonding authority. The likely reason for this omission is that the laws regarding bonding were in place prior to the introduction of charter schools. What other states have done is merely go back and include charter schools in that list, therefore making it explicit to bonding authorities that charter schools are eligible. Most recently, policymakers have taken this action in Colorado (see below), NC (Senate Bill 1556), and Texas (House Bill 211). Furthermore, there has been interest in Pennsylvania to allow charter schools to go through a bonding authority such as Pennsylvania’s State Public School Building Authority (SPSBA). Proposals permitting the use of PPSBA have

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\* It’s important to note that there are two broad types of tax-exempt bonds—*general obligation bonds* that are backed by governmental taxing power, and *revenue bonds* that are backed solely by the projected revenue and assets of the project financed by the bonds. General obligation bonds are the most advantageous for borrowers; but since charter schools lack taxing power, charter school financing typically takes the form of revenue bonds.

stalled due to the restriction in the law placed on charter schools use of state revenues for new construction (see Prohibition on the Use of Operating Revenue for New Construction below).

- In 1998, Colorado Senate Bill 82 expanded the list of eligible beneficiaries of the new Colorado Education and Cultural Facilities Authority (previously the Colorado Postsecondary Facilities Authority). This list now includes organizations with “an educational program pursuant to a charter from a school district.” As of November 1999, six charter schools had raised over \$22 million in capital by issuing tax-exempt bonds through the Authority. Taking this one step further, the Colorado League of Charter Schools, in partnership with the Authority, will be piloting a Charter School Bond Program that will enable schools with smaller capital needs to tap bond funds. Charter schools with enrollment of at least 100 students and that have been operating for three years or more will be eligible for loans ranging from \$500,000-\$2 million. A total of \$10-\$15 million will be allocated for this pilot program. The Colorado League of Charter Schools (CLCS) will serve as the program administrator.

#### Considerations:

- Two possible approaches to this issue are: (a) enacting legislation making it clear that charter schools are eligible recipients of the proceeds of tax-exempt bonds issued by one or more other agencies, and (b) enacting legislation enabling charter schools to issue tax-exempt bonds directly.
- Under either approach, charter schools would enjoy many of the same benefits as other public institutions in regards to facilities financing. Not giving charter schools access to tax exempt financing puts them at a disadvantage; without it, the schools are required to use solely private means of financing their facilities, resulting in higher interest rates.
- The exact language required to give charter schools access to tax-exempt financing varies from state to state. Policymakers will also want to investigate whether such access would have any negative implications for charter schools under Pennsylvania state law. For example, would status as a public entity create certain obligations for charter schools (regarding reporting, board membership, etc.) that would impose unacceptable burdens on charter schools?
- Even with access to tax-exempt financing, not all charter schools will be able to tap the bond market because of the small size of their projects and/or their lack of track record and net worth. One option is to create a risk reserve — a pool of funds that enables smaller or riskier charter school projects to gain access to bond market.

- Another issue facing state policy-makers is where to place the authority to issue bonds on behalf of charter schools. One approach is to designate a single entity, as Colorado did. The advantages include: (a) a concentration of charter school expertise within a single agency; (b) a mechanism of accountability for charter school finance within a state; and (c) the facilitation of pooling arrangements like the one described above. Another approach is to empower multiple entities to issue on behalf of charter schools. Arizona authorized all of its Industrial Development Authorities to do so, but policy could engage an even broader set of actors by tapping cities, counties, or other governmental units. The advantages of this approach include: (a) minimizing the degree to which political or other changes have the potential to restrict the flow of capital to charter schools in the future; (b) creating more of a market for charter school financing, providing incentives for issuers to offer favorable terms.

### **C. Prohibition on the Use of Operating Revenue for New Construction**

**Policy Issue:** Charter schools in Pennsylvania are not allowed to use their operating revenue for new construction.

**Suggested Policy Modification:** Permit charter schools to use operating revenues for all needs associated with the school, including financing new construction.

**Discussion of Issue:** Many states allow charter school to use their operating revenue for capital outlay. For example, many charter schools in Colorado are creating capital reserves out of their annual operating budgets, allowing them to save money over time that can be used to finance future facilities needs.

#### **Considerations:**

- Not allowing a charter school to use public monies for its capital needs is especially limiting for those schools located in areas where adequate rental properties are scarce or where there is little private support for charter schools (e.g., private foundations are often contributing towards the capital needs of charter schools located in larger cities but there are fewer of these entities in rural, or even suburban, areas).
- By owning its facility, instead of renting it, a charter school can lock in a mortgage payment, allowing the school to plan for its future and not have to worry about the cost of the facility increasing over time, as would likely be the case when leasing a facility.
- One reason why Pennsylvania may discourage public funding of facilities may have to do with what happens in the event of dissolution. Policymakers may want to ensure that capital assets financed with public funds remain in the public domain even if a charter school shuts down. In enacting such a provision, though, policymakers

must take care to ensure that lenders to charter schools can still claim collateral to repay the debts owed by a failed charter school. Otherwise, lenders will not be willing to extend credit to charter schools. For example, North Carolina addressed this issue as follows: *Upon dissolution of the charter school or upon the non-renewal of the charter, all net assets of the charter school purchased with public funds should be deemed the property of the local school administrative unit in which the charter school is located.* §115C-239.29F(i). The word “net” ensures that creditors can be satisfied before any assets revert.

#### **D. Lender Uncertainty about Charter Renewal**

**Policy Issue:** Investors called upon to make 15-30 commitments to charter schools are often concerned about the fact that the school's charter will come up for renewal in only 3-5 years. Pennsylvania's charter schools are currently approved for a term of five years (or less).

**Suggested Policy Modifications:** The state and authorizers should clarify the process of charter renewal and explain it in language that investors can understand. The state should encourage authorizers to work with schools to adopt rigorous, objective and clearly understood charter approval and oversight and accountability protocols that make it clear what factors will be considered in approving and renewing charters and, in rare cases, terminating charters mid-term.

**Discussion of Issue:** Some states (Arizona, the District of Columbia, Michigan and Colorado) have responded to this issue by lengthening the allowable term of the charter to as much as 15 years or even the length of the loan. The length of the charter term, however, should be primarily an aspect of each school's accountability to its sponsor and not be used to give what might be false assurances to a lender. Most state charter laws provide for an annual review of schools by the authorizers and make it possible for charters to be terminated mid-term for specified reasons. So even having a 15-year or longer charter doesn't really provide any greater security to a lender than, say, a three or five-year term.

Instead of having the term length closer to the length of real estate loans, a more prudent course would be to take steps to ensure a fair yet rigorous approval process for all charter applicants and maximum openness, certainty and objectivity to the oversight and renewal process used by authorizers. In addition to having a strong academic program, applicants should be able to demonstrate strong administrative and fiscal management capacity at the time they seek a charter. And, once approved and operating, charter schools (and their lenders) should know at all times where they stand vis-a-vis compliance with their original charter agreement, particularly as they approach renewal. Taken together, these steps will do far more to reduce lender uncertainty than linking term lengths to loan repayment schedules and strengthen, not weaken accountability to the charter authorizer.

Considerations: Regardless of the term of the charter, policies and procedures regarding accountability should be clearly articulated and in place, making the future less arbitrary and uncertain to lenders or investors.

### **E. Minimal Access to High-Risk Capital**

Policy Issue: There are charter schools in Pennsylvania, especially new ones without a proven track record, that will look too risky to investors and therefore, will not be able to obtain the low-cost financing that other public schools in the state can access.

Suggested Policy Modifications: Use state appropriations to create or expand charter school facilities loan pools.

Discussion of Issue: Investors that see charter schools as too risky may refuse to provide financing at all or they may charge a steep premium that is unfeasible or that eats deeply into a charter school's operating budget. Even if Pennsylvania opens up access to tax-exempt financing, as described above, many PA charter schools will not be able to take advantage of it for this reason. Chicago Public Schools created a charter school loan pool to provide low-cost capital to charter schools that fall outside traditional underwriting guidelines. Managed by the Illinois Facilities Fund (a nonprofit community development financial institution), the pool offers loans with an interest rate of 5 percent. This source provides loans at rates much lower than what the market offers and makes credit available to schools that would not be able to obtain it conventionally.

Pennsylvania has two organizations (the Reinvestment Fund in the Philadelphia area and the Community Loan Fund of Southwest Pennsylvania in the Pittsburgh area) that have initiated charter school loan pools on their own. Entities such as these are currently raising money solely from the private sector and would benefit greatly from some public backing, as it would likely mean that they could serve more charter schools as well as provide loans at lower rates.

Considerations: See pages 12-16 of *Paying for the Charter Schoolhouse* for more discussion on this issue, including items for further consideration.

### **III. Summary of Suggested Policy Modifications for Charter School Financing in Pennsylvania**

1. Create a separate state funding stream to support capital outlay in charter schools and/or include charter schools in the state's system for funding school facilities.
2. Modify the law to include charter schools in the list of entities that are eligible to use a public body to issue bonds on their behalf and explore the issue of allowing charter

schools to issue their own bonds.

3. Permit charter schools to use operating revenues for all needs associated with the school, including financing new construction.
4. Use state appropriations to create or expand charter school facilities loan pools.

And, while it's not necessarily a policy modification as much as it is a recommendation — clarify and strengthen the process of charter renewal, explain it in a language that investors can understand.

#### **IV. Conclusion**

While Pennsylvania has started to address the charter school facilities challenge, it still needs to look more closely at the issues raised in this brief in order to put charter schools on a level playing field with other public schools in the state (in regards to facilities funding). For a more comprehensive discussion of these issues, along with other issues related to charter school facilities finance, please read the Charter Friends National Network's document, *Paying for the Charter Schoolhouse*. The document is available online at:

[www.charterfriends.org/facilities.html](http://www.charterfriends.org/facilities.html)

or by contacting the Friends Network at (651) 649-5479. Questions or comments about this Pennsylvania policy brief may be directed to the authors: Bryan Hassel (704-370-0357 or [Bryan\\_Hassel@publicimpact.com](mailto:Bryan_Hassel@publicimpact.com)) or Amy Berk Anderson (303-494-3720 or [aba@xpert.net](mailto:aba@xpert.net)); or to Bruno Manno at the Annie E. Casey Foundation (410-223-2983 or [BrunoM@aeffc.org](mailto:BrunoM@aeffc.org)).

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