



ADDRESSING CALIFORNIA'S SCHOOL AND UNIVERSITY BUILDING NEEDS: ALTERNATIVES TO PROPOSITION 1D

By Lisa Snell





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By Lisa Snell

Executive Summary

Proposition 1D would authorize \$7.3 billion in general obligation debt for primary education (K-12) and \$3.1 billion for higher education facilities. Together, this debt package would have annual debt service costs of \$680 million per year and a total cost to taxpayers of \$20.3 billion. This money would be available to fund construction for modernization projects, new construction, and vocational education facilities, among other uses.

Over the past ten years, state voters have authorized \$28.1 billion in general obligation debt for K-12 school facilities. Approximately \$3 billion of these funds remain unused at this time. Additionally, local school district voters have authorized an additional \$41 billion in local bonds to fund school construction. School construction is also supported by developer fees paid when new homes are built. Overall, California has made a \$95 billion dollar investment in K-12 and higher education facilities over the past decade.

Yet, state general obligation bond funding is a poor way to finance school construction. It is expensive (interest payments make it nearly twice the cost of the principal), places an unfair debt burden on future generations, and represents a cop-out by legislators unwilling to make difficult decisions to provide funding through the normal budgeting process. This gives politicians greater incentives to spend money irresponsibly on pet projects and programs and then rely upon desperate voters to fund "critical" programs by asking them to approve infrastructure bonds. Local bonds tend to be more accountable and more closely tied to real local needs and are a better way to use debt where appropriate for building new schools.

In addition, Proposition 1D leaves the current school facility program in place and does not address the inherent problems with the school facility process in California.

The complex regulatory process in California forces long delays in school construction while other factors, such as prevailing wage rules, increase the cost of school projects. Local school districts also play a significant role in the inefficient use of school construction funding. Districts vary drastically in their construction approaches, accounting methods, contracts and budgets, so it's difficult for the public to know when money is wasted or lost. There is no single state watchdog agency that ensures that districts spend bond money efficiently.

Proposition 1D also does not earmark any money for districts facing growing enrollment. Instead it creates a free-for-all atmosphere where the savviest districts may win more of the bond money. Yet there are clear shifts in enrollment patterns from one district to another.

It also fails to place the primary responsibility for school construction funding at the local level which would offer school districts the financial incentive to better manage their school facilities programs. In California both the school construction financing mechanism and the actual school building process need to be reformed with incentives for school districts to utilize innovative school building strategies such as lease-leaseback and developer-built schools.

Rather than a series of large-scale state-level general obligation bonds to fund school construction in California the state should fund schools at the local level. Growing areas should be able to cover the majority of their new school costs through developer fees—especially if they utilize developer built schools. In rapidly growing areas, districts should rely heavily on developer-built and lease-leaseback arrangements to build new capacity quickly. In addition, a state-level per-pupil component that is financed out of the general fund should give local districts a stable funding source that can be bonded against or aggregated over time to fund schools.

Public-private partnerships should play an important role in the development of new schools in California. Because the private builder assumes the risk of building a new school and has real money to lose from construction delays, he has an incentive to build schools quickly and under or at budget. Since the developer finances the school up-front school districts or the state can redirect school construction bond money to more efficiently modernize and build new schools.

The state level per-pupil facility grants should offer districts an incentive for using innovative private delivery mechanisms to build schools quickly for a lower cost. The state level financing from the general fund should include performance incentives for those districts that build schools on time and on budget. A 10 percent reward above the states per-pupil allocation would be appropriate for those districts that leverage state construction funds to build schools in a timely manner. The public-private partnership is one mechanism for achieving that goal. A school district could offer builders financial rewards for on-time performance. However, any school district that can build schools on budget within a pre-set time frame should be eligible for performance bonuses above the minimum level of state funding.

Many California children continue to languish in deteriorating and overcrowded classrooms in spite of the fact that in the past decade California has made a massive \$95 billion investment in K-12 and higher education infrastructure. Proposition 1D would continue this trend with another \$10.1 billion education bond. Yet, the proposition offers no help for the school children who are stuck with deteriorating schools, not because of a lack of funding, but because of the highly-regulated school construction process and the ineptitude of school district facility programs. It is time to revamp the school construction process in California. Regulations should be streamlined, local districts should take the primary responsibility for their school facilities needs, the districts should utilize the cost saving benefits of public-private partnerships, and the work should be performance-based to ensure that school districts build schools on time and on budget.

For more information on this issue and others on California's November Ballot, go to reason.org/californiaballot/

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Part I

Introduction

In the last decade California voters at the local and state level have approved more than \$95 billion in school construction bonds for K-12 and higher education facilities. Despite the availability of massive amounts of school facility capital in California, some school districts continue to suffer from chronic shortages of classroom space and deteriorating school facilities. Governor Schwarzenegger's Strategic Growth Plan (SGP) estimates that California will need new facilities for 250,000 K-12 students and that 1.1 million students attend schools in need of modernization. The SGP also estimates that higher education enrollment will grow by 600,000 students in the next decade. Therefore, the SGP proposes \$38 billion in general obligation bonds over the next decade to fund the state's share of California's K-12 and higher education school facility needs. Proposition 1D is the first installment of the state's plan to fund school construction in California and places \$10.1 billion in general obligation funds for K-12 and higher education on the November 2006 ballot.

Historically, California has used state general obligation bonds and local bonds to pay for school infrastructure. While new school capital outlays and modernization are ongoing needs for school districts, the funding source is set up on a feast or famine scheme. Rather than the state floating general obligation bonds and then determining which districts are eligible for per-pupil funding, school facilities should be a local decision. Schools ought to raise the majority of school facility funds at the local level. At the state level schools need a reliable per-pupil facilities financing allotment that follows each child into the school district and sets up a stable funding stream funded out of existing tax revenue from year to year. School districts can use this stable funding stream to bond against or to pay for innovative public-private partnerships. The state should design a per-pupil allotment for facilities so that schools would have a regular stable amount of financing based on the number of children that enroll—rather than unpredictable bonds that fund individual projects.

It takes many years to build a school in California. The complex regulatory process coupled with mismanagement at the district level and other factors such as prevailing wage rules significantly increase the cost of building a school. The school construction process is time-consuming and suffers from over-regulation. The result is that building a school can take up to six years, sometimes more. The longer it takes to build a school the more it costs. The current bond measure makes no attempt to reform the cumbersome and heavily regulated school construction system. It

fails to prioritize resources to those districts experiencing growth. It also fails to place the primary responsibility for school construction funding at the local level which would offer school districts the financial incentive to better manage their school facilities programs. In California both the school construction financing mechanism and the actual school building process need to be reformed with incentives for school districts to utilize innovative school building strategies such as lease-leaseback and developer-built schools.

Part 2

Proposition 1D Overview

Governor Schwarzenegger's Strategic Growth Plan (SGP) proposes to place \$38 billion in Education general obligation bonds before the voters in the next decade—\$26.3 billion for K-12 education and \$11.7 billion for higher education.¹

The plan anticipates that in the next ten years college enrollment will grow by 600,000 students and that the K-12 education system will enroll 250,000 additional students. The SGP also points out that California's system of 8,000 school sites will continue to age and need significant investment in modernization.

The ten-year SGP includes a series of general obligation bonds totaling \$26.3 billion for K-12 education facilities needs through 2016-2017. The first \$7.3 billion for K-12 will be on the November election ballot with the remaining \$17 billion scheduled for election cycles through the year 2014.

The ten-year SGP also includes general obligation bond measures totaling \$11.7 billion for higher education facilities needs. The higher education bond is proposed to fulfill a compact with the University of California and California State University. It also provides the same bond amount for California's community college system. In the first five years, the proposal includes \$5.2 billion for the higher education compact and the community colleges. For the second five years the plan includes \$6.1 billion for the three segments.

The first installment of the governor's Strategic Growth Plan is the Kindergarten-University Public Education Facilities Bond Act of 2006. The state would sell \$10.4 billion of general obligation bonds for K-12 school facilities (\$7.3 billion) and higher education facilities (\$3.1 billion). The bond will cost a total of \$20.3 billion to pay off both the principal (\$10.4 billion) and interest (\$9.9 billion) on the bonds. Payments will be about \$680 million per year.

The California Secretary of State prepared the following ballot summary for Proposition 1D:

This ten billion four hundred sixteen million dollar (\$10,416,000,000) bond issue will provide needed funding to relieve public school overcrowding and to repair older schools. It will improve earthquake safety and fund vocational educational facilities in public schools. Bond funds must be spent according to strict accountability measures. Funds will also be used to repair and upgrade existing public college and university buildings and to build new

classrooms to accommodate the growing student enrollment in the California Community Colleges, the University of California, and the California State University.

This measure allows the state to sell \$10.4 billion of general obligation bonds for K-12 school facilities (\$7.3 billion) and higher education facilities (\$3.1 billion).

The K-12 bond money is to be distributed on a project basis to about 1,000 local school districts that provide education from kindergarten through grade 12 (K-12) to about 6.3 million students. Except for the \$1 billion earmarked for severely overcrowded schools, the projects are funded on a first-come first served basis. The governor’s Strategic Growth Plan claims that the \$7 billion for K-12 will fund approximately 9,700 new classrooms that house 252,000 students and 38,800 modernized classrooms for over 1 million students.

The higher education bond money is shared by the three segments of California’s higher education system which includes the California Community Colleges (CCC), the California State University (CSU), and the University of California (UC). These three higher education segments provide education beyond grade 12 to a total of about 2.1 million students. The governor and legislature would select the specific projects to be funded by the \$3.1 billion bonds for higher education.

Table 1: Proposition 1D: Uses of Bond Funds	
K-12	Amount (In Millions)
Modernization projects	\$3,300 ^a
New construction projects	1,900 ^{a,b}
Severely overcrowded schools	1,000
Charter schools facilities	500
Career technical facilities	500
Environment-friendly projects	100
Joint-use projects	29
Subtotal, K-12	(\$7,329)
Higher Education	
Community Colleges	\$1,507
University of California	890 ^c
California State University	690
Subtotal, Higher Education	(\$3,087)
Total	\$10,416

^a A total of up to \$200 million is available from these two amounts combined as incentive funding to promote the creation of small high schools.

^b Up to \$200 million is available for earthquake-related retrofitting.

^c \$200 million is available for medical education programs.

Source: Legislative Analyst’s Office

A. The K-12 School Facility Funding Process

Through the School Facility Program (SFP), K-12 school districts apply for funding to buy land, construct new buildings, and modernize existing buildings. A school district's allocation is based on a formula. The formula considers the number of students a district expects to enroll that cannot be served in existing facility space. The SFP requires the state and school districts to share the cost of facilities. For new construction projects, the cost is shared equally by the state and school districts. For modernization projects, the state pays 60 percent and school districts pay 40 percent of the cost. If a school district faces unusual circumstances, however, it may apply for "hardship" funding from the state to offset its share of costs.

According to the Office of Public School Construction (OPSC), approximately \$3.9 billion of the state level K-12 bond funds were uncommitted as of June 2006. The OPSC also projects an unmet need of \$11.02 billion in new construction eligibility. This amount of unmet new construction need is based on a five-year projection of enrollment in comparison to the seating capacity for each district in the State. This figure is based on all SFP eligibility applications filed, processed, and approved by the State Allocation Board. Some districts may not have updated their enrollment data or seating capacity for new classrooms constructed with local funds so this estimate is based on the data that is currently available.

B. The Higher Education Facility Model

The May 2004 "Compact with Governor Schwarzenegger" addresses the capital program needs of the University of California (UC) and California State University (CSU) systems and includes a commitment to continue this level of funding through either general obligation bonds or lease-revenue bonds through 2010-11.² Although the state funds only a portion of the University of California's capital needs, there is a comprehensive shared view of capital investments needed to support the University's programs based on growth targets and facilities standards. The University of California's capital program is funded from a combination of voter approved bonds, lease revenue bonds, and other fund sources such as private giving and research grants. In exchange for this commitment of long-term stable support, UC and CSU have committed to accountability goals for enrollment, resource utilization, student fees, financial aid, and program quality.

More specifically, according to the governor's Strategic Growth Plan the 2006-2007 budget allocation for each of the three segments includes:

- \$315.4 million for construction and renovation of 29 buildings on UC campuses.
- \$234 million for construction and renovation of 15 buildings on CSU campuses.
- \$471.7 million for 58 buildings in 38 community college districts.

Part 3

Problems with the Bond's Approach

Proposition 1D leaves the current school facility program in place and does not address the inherent problems with the school facility process in California. Why is it so difficult to build schools? Why does it cost so much? Why does it take so long?

A. Does Not Assess School Facility Needs

The state lacks a comprehensive assessment of school facility needs and the resources needed to address them. California's school facility program does a poor job of calculating accurate school enrollment from one district to another. School facility funds need to be prioritized based on enrollment growth. For the first time in 23 years, California's public school enrollment will show an absolute decline. The 2005-06 average daily attendance is expected to be almost 20,000 fewer than was reported in 2004-05. Current Office of Public School Construction (OPSC) data show that districts are eligible for new construction based on almost 800,000 students and for modernization based on 1.1 million students. The OPSC estimates that the cost to fund these projects is about \$11 billion for new construction and \$3.6 billion for modernization.

However, these estimates by OPSC are highly inaccurate and based on severely outdated data. Districts are only required to update their eligibility when they apply for new bond funds. If they have not accessed new construction funds for several years the OPSC will not have updated enrollment data for these districts. So, for many declining enrollment districts, this data does not reflect the current facility needs.

Both the Senate education committee and the Assembly education committee noted that they could not determine the facilities needs in California during their hearing on Proposition 1D. In addition, according to the California's Legislative Analyst's Office, Governor Schwarzenegger proposes a ten-year plan for new school construction spending without providing a detailed assessment of facility needs or accounting for declining K-12 enrollment. By state statute, Schwarzenegger is supposed to file a detailed school facilities needs assessment.

The method the administration used to calculate the general obligation bond needs for future school facility building is also questionable. The plan uses an average monthly cost for new

construction (\$101 million) and modernization (\$83 million) for the last three years to define future need. The plan assumes that this level of need continues for the next ten years and adds 3.5 percent for inflation. This results in a calculation of \$23 billion in K-12 facilities needs for the next ten years.

This method is flawed because it does not take into consideration the tremendous increase in school construction over the last five years as \$21 billion in state funds and \$35 billion in local funds were made available to school districts. This represented a “catch-up” level of school facilities financing that may not be required to sustain school facilities over the next decade. In addition, the funding calculation of \$23 billion does not account for the demographic shift in K-12 enrollment. A majority of school districts are facing declining enrollment for the next several years. The slow enrollment growth will actually reduce demand for new schools and may even force some under-enrolled schools to close. In addition, districts with under-enrolled schools may continue with plans to build new schools that are not justified by student enrollment. Dianne Feinstein Elementary, a new school that has just opened for the fall 2006 school year in San Francisco is a case in point. The school took ten years to build and San Francisco’s student enrollment changed dramatically over the decade that the district was attempting to build the school. In the years after the 1997 bond was passed, district enrollment declined, forcing school officials to close several schools across the city. San Francisco parents and taxpayers were left to wonder why millions were going toward a new school when other schools sat empty for lack of students.³

Yet, other districts are still facing growing enrollments. For example, Los Angeles is projected to lose 10 percent of its enrollment over the next ten years while Riverside is projected to gain 35 percent more enrollment. The current method used to finance school construction serves districts on a first-come first serve basis and may over-invest in districts with declining enrollment. For example, a declining enrollment district could apply for modernization funds for several older schools, yet the district’s enrollment patterns may support making the tough choices to close some schools and focus scarce modernization funds on those that are not under-enrolled. The availability of large infusions of state-level capital gives local school districts the wrong incentive to invest resources in every school.

The school bond does not earmark any money for districts facing growing enrollment. Instead it creates a free-for-all atmosphere where the savviest districts may win more of the bond money. Yet there are clear shifts in enrollment patterns from one district to another.

Rather than using general-obligation bonds, the funding mechanism for school facilities should move to a per-pupil yearly student allotment that would disburse funds evenly on a yearly basis based on the actual enrollment of each district. This stable school facilities fund should be funded on a pay-as-you-go basis from the general fund, rather than through long-term debt financing. The state facility allotment should not be the primary financing mechanism but instead a supplemental funding stream that allows local districts to plan for long-term facilities needs and a stable revenue stream which school districts could bond against at the local level.

B. The High Cost of Regulation

Over the past few years, California voters have approved large numbers of expensive state and local school facilities bonds. Despite the availability of large amounts of construction funding, it takes many years to build a new school in California. The longer it takes to build a school; the more the school costs. Under the traditional building method, it takes about five to six years to build a school if the process works smoothly.

The complex regulatory process in California forces long delays in school construction while other factors, such as prevailing wage rules, increase the cost of school projects. According to a study by the Pacific Research Institute, a Los Angeles Unified School District commission found 117 required steps in the school construction process, including: an assessment to determine where schools are needed; finding a site; condemning the land and acquiring it; commissioning a design; getting approval of various environmental permits; mitigating environmental problems; relocating existing residents or tenants; applying for state funds; and placing contracts out for bid.⁴

1. Field Act

The mandate of Field Act legislation, passed in 1933 shortly after an earthquake destroyed several public schools in Long Beach, is to ensure earthquake safety for children attending public schools. It does so with a multitude of structural and inspection standards regulating public school site selection and construction. The Office of the State Architect is the state governing body that ensures that plans for new buildings and modifications to existing sites conform to Field Act standards.

Field Act standards are more stringent than Uniform Building Code (UBC) standards, although in recent years as both codes have undergone revisions, that gap—as it pertains to structural requirements—has nearly closed. Field Act standards are also more costly to meet than UBC requirements. Additional regulations in the Field Act increase the cost of construction by three to six percent over the cost of UBC construction, according to a study by the Office of the State Architect. The Pacific Research Institute points out that the primary difference between the Field Act and the UBC is not construction standards but the process of inspection and reporting.⁵ The Field Act requires continuous inspection and requires construction to be observed by a structural engineer.

A June 2003 study of the regulations imposed on the school construction process since it was revamped by the 1998 School Facility Program found that newly imposed regulations have lengthened the time required to complete new schools, thereby increasing the costs beyond the direct costs of complying with the regulations.⁶ In other words, schools pay for the cost of regulation and the cost of delayed construction projects. Between 1999 and 2004, the cost per acre to acquire land for school sites has increased from \$2.3 million to \$4.2 million, or an average of 15 percent per year. Costs to build schools in California have increased by about 6.5 percent per square foot on average each year between 1999 and 2005—or about 48 percent. “In an

environment of rapidly rising land and construction costs delays can significantly increase total project costs.”⁷

Major New Requirements Since 1998:

- Hazardous Substance Contamination
- Storm Water Requirements
- Labor Compliance Program
- Fire Suppression
- Energy Efficiency
- Access Compliance (ADA)
- Geo Technical Studies
- Air Quality Requirements
- Building Code Changes

2. Prevailing Wage Laws

One specific type of regulation that has a substantial effect on the cost of school construction is prevailing wage laws. Studies have shown that these regulations alone can increase school construction costs by 25 percent.

School construction also bears significant costs to comply with a Labor Compliance program that certifies that builders are actually paying the prevailing wage. Legislation enacted in 2002 requires school districts to enforce a labor compliance program as a condition of receiving 2002 and 2004 bond money. Each district must establish a labor compliance program or hire a third party to enforce prevailing wage rules. Districts interviewed in the school facility cost study reported that contractors have been defining all construction tasks as skilled (therefore eligible for the prevailing wage) rather than risk potential violations.⁸

An Ohio Legislative Service Commission study found that a 1997 law exempting public school construction from prevailing wage laws reduced the cost of school construction by 10.7 percent.⁹ The study also found no evidence that the prevailing wage exemption decreased the quality of school construction. If California had a prevailing wage exemption that resulted in a 10 percent decrease in cost, schools could save close to \$1 billion on the \$10 billion bond proposal. However, Proposition 1D mandates both the prevailing wage requirement and participation in the labor compliance program.

C. Mismanagement of Funds at the District Level

In addition to expensive regulatory requirements at the state level, local school districts also play a significant role in the inefficient use of school construction funding. Districts vary drastically in their construction approaches, accounting methods, contracts and budgets, so it's difficult for the public to know when money is wasted or lost. There is no single state watchdog agency that ensures that districts spend bond money efficiently.

Districts Over-promise and Misuse Bond Funds

Unfortunately, school districts have a long history of school construction boondoggles fraught with fraud and mismanagement. School district waste of bond monies runs the gamut from outright fraud to poor capacity to manage large-scale school construction processes.

One case of outright fraud occurred in the San Francisco Unified School District. School officials used as much as \$100 million of bond and tax money to support a sprawling bureaucracy and to finance ill-conceived construction projects that ran far over budget. Most of that money — as much as \$68 million—was spent on salaries for non-teaching employees, including several officials who are now the focus of corruption investigations. One official stole more than \$850,000 from the district.

On the other hand, many school districts simply do a poor job of managing the school construction process. The McNair High School in the Lodi Unified school district is a case in point. The school will cost \$86 million, \$26 million over the proposed cost of \$60 million. The cost overruns were caused by multiple contract disputes, numerous construction delays, and a large number of change orders.

Similarly, a June 2006 investigation by the *Orange County Register* examined 19 school districts that passed \$1.7 billion in local school bonds and found that only six districts were delivering on the projects that were promised to taxpayers to win approval of the bonds.

- Anaheim Union High School District squandered nearly one-third of a billion dollars. According to the *Orange County Register*, mismanagement of a \$330 million construction program forced Anaheim Union officials to drop all but eight schools from a 22-campus improvement project. Costs for the eight schools ballooned from \$177 million to \$255 million because of rising prices, budgeting errors, and a multitude of oversight failures at the school district.
- La Habra City School District scrapped classrooms at three schools when costs shot up 34 percent. Enrollment also dropped, reducing need.
- Santa Ana Unified planned 13 schools and 11 renovations, but district employees and the former school board miscalculated land costs and construction expenses.

- With voter approval of a \$165 million bond issue in November 2002, and \$85 million anticipated in state matching funds, Norwalk-La Mirada Unified School District appeared to have enough to complete an ambitious modernization plan. But now, the plans to give every school air conditioning, computer data ports, and new windows and sinks have run into cost overruns. Costs are projected to be \$100 million over the \$231 million originally budgeted in 2002. It appears eight of the district's 28 schools do not have enough money to complete projects.

The poster child of school construction nightmares is the Belmont Learning Center in Los Angeles. It has been in the works for almost a decade and yet no child has ever attended the school. In November 2005 the Los Angeles School Board approved \$132 million to complete construction, raising the total cost to more than \$300 million. State officials stopped construction on the campus in 1999 because it was being built on top of potentially explosive methane and toxic hydrogen sulfide gases. When an earthquake fault was discovered under part of the school, two buildings were torn down and the campus was reconfigured in 2002. A consultant had warned about the earthquake danger years before construction began. Belmont Learning Center has the distinction as the most expensive high school in the state.

Showcase Schools

Districts also choose to build lavish showcase projects that take bond money away from other needy schools. In Los Angeles the school board voted in 2006 to build a showcase downtown performing and visual arts high school now estimated to cost \$208 million — double that of a typical high school. The campus would cost more than twice what school district officials initially had expected. The original plan for the school site almost five years ago was to build a high school for \$54 million to relieve overcrowding for a long-underserved community. To date, the school site has been graded. Similarly, Sacramento is building a signature high school that will cost millions more than high school projects in nearby districts. For example, a neighboring school in the Elk Grove Unified School District is taking bids on building a high school and middle school for 3,500 students on a shared 300,000-square-foot campus. That project is expected to cost \$112 million. Compared with the Sacramento design, the Elk Grove school puts more than 1,000 more students in the same amount of building space.

D. Lack of Accountability in the Bonding Process

In the official arguments in favor of Proposition 1D proponents claim that the measure has strict accountability provisions: “Every dollar must be strictly accounted for on a project-by-project basis with independent state and local audits. Misuse of funds is a crime, punishable by imprisonment.”

These are the same accountability provisions that have been in place since Proposition 39 was passed in 2000. Proposition 39 changes the state constitution to lower the threshold for voter

approval to 55 percent for bond measures for school facilities in local elections and provides for repayment of the bonds with local property tax increases. Proposition 39 required the creation of independent citizens' oversight committees and independent audits and the penalty of prison for misuse of funds.

Unfortunately, these accountability procedures have done little to combat incompetence in the building of California schools. While the accountability provisions may prevent outright fraud, they have done little to stop the inefficient use of bond money. If a school district spends \$100 million over the projected cost, as long as all the money went to the school construction process and was not stolen or spent on district salaries, the audit offers no relief for taxpayers or children waiting for a seat in a new or improved classroom.

These accountability measures do nothing to change the long delays experienced in most school construction projects that drive the costs to double and triple and offer school districts no real incentive to be good stewards of the public trust.

E. State Obligation Bonds Are A Costly Way To Pay For School Construction

State general obligation bond funding is a poor way to finance school construction. It is expensive (interest payments make it nearly twice the cost of the principal), places an unfair debt burden on future generations, and represents a cop-out by legislators unwilling to make difficult decisions to provide funding through the normal budgeting process. This gives politicians greater incentives to spend money irresponsibly on pet projects and programs and then rely upon desperate voters to fund "critical" programs. Local bonds tend to be more accountable and more closely tied to real local needs and are a better way to use debt where appropriate for building new schools.

To the extent that the state finances school construction, this financing should be paid every year out of the general fund on a pay-as-you-go basis. For example, Governor Schwarzenegger has increased education spending by \$4 billion for the 2006-2007 budget on top of a \$3 billion funding increase in the 2005-2006 budget year. California will now spend more than \$66 billion on education. Yet, none of the \$7 billion in new education funding was earmarked for school construction. Schwarzenegger has introduced a host of new categorical "pet" education projects that will need ongoing year to year budget commitments—from \$85 million for physical education grants to \$20 million for fruits and vegetables in schools and \$37.8 million to increase the quality of food to \$428 million for after school care. These "new" programs are examples of how California continues to spend money irresponsibly and yet does not have general revenue to invest in something as critical as school facilities.

Governor Schwarzenegger should follow Arizona's Democratic Governor Janet Napolitano's lead and put an end to state-level debt financing for the construction of new schools. Revenues are up in Arizona, and the legislature and Governor Napolitano have agreed to pay for future new school construction out of the general fund. In California Schwarzenegger could begin with the revenue

that is set aside for the \$680 million in debt financing to offer school districts a reliable per-pupil grant for school facilities. This would help equalize school construction funding by providing districts facilities money based on their actual average daily attendance (ADA) rather than the first come first served system that is now in place. It would also give schools a reliable year to year revenue source to bond against at the local level.

Part 4

Addressing California's School Construction Needs: Alternatives to Proposition 1D

A. Fund Schools at the Local Level

California should shift the responsibility of funding school construction to the local level. Growing areas should be able to cover the majority of their new school costs through developer fees—especially if they utilize developer built schools. In rapidly growing areas, districts should rely heavily on developer-built and lease-leaseback arrangements to build new capacity quickly. In addition, a state-level per-pupil component that is financed out of the general fund should give local districts a stable funding source that can be bonded against or aggregated over time to fund schools. This should be a stable funding source that allows districts to predict their year to year state level support for capital expenses.

B. Consider a State-Level Private Finance Initiative for New Schools

The second option would be to follow the model of the United Kingdom's Private Finance Initiative. Rather than just incorporating private school construction delivery options into school district building plans, the legislature could offer a competitive building plan for private developers to build out all schools in California. The Office of Public School Construction estimates that immediate school facility needs are approximately \$14.5 billion for all school modernization and new construction. The state could use general revenue to pay long-term lease payments to consortiums of private developers who could quickly build new schools in California. The money paid to developers could be in lieu of the \$20 billion it will cost to finance the principal and interest on Proposition 1D's \$10 billion bond. The advantage of this approach would be that the developers could finance the schools and assume the risk and it would allow many schools to be built at one time. The developers could be given performance based contracts to ensure they build the schools on time and on budget.

C. Eliminate the School Facility Program

If school districts receive state facility grants on a per-pupil funding basis based on average daily attendance and generate the majority of bond revenue at the local level, there will be no need for a state level agency to determine who is eligible for school building construction funds. School districts can plan all of their school facility needs without worrying about state approval. Under local financing of public schools any district could build a school as long as they have the money and meet the building codes and other regulations. The state does not need to manage which districts are permitted to build schools. The school facility program can focus on streamlining the permitting process through the Office of Public School Construction and the Office of the State Architect—acting more like a state-level building department than a funding eligibility program.

D. Use Performance-Based School Facility Grants

The state level per-pupil facility grants should offer districts an incentive for using innovative private delivery mechanisms to build schools quickly for a lower cost. The state level financing from the general fund should include performance incentives for those districts that build schools on time and on budget. A 10 percent reward above the state's per-pupil allocation would be appropriate for those districts that leverage state construction funds to build schools in a timely manner. The public-private partnership is one mechanism for achieving that goal. A school district could offer builders financial rewards for on-time performance. However, any school district that can build schools on budget within a pre-set time frame should be eligible for performance bonuses above the minimum level of state funding.

E. Survey Actual School Enrollment in California Districts

In order to determine the appropriate level of per-pupil state facility grants, the legislature should require a survey of student enrollment numbers for every district. All future allocations of state money whether bond money or facility grants should reflect actual enrollment numbers based on up to date district demographics rather than projections that were made in years past. All future revenue for new school construction should be prioritized to districts with growing enrollment or overcrowded schools on a per-student basis.

F. Repeal Unnecessary Building Codes and Regulations

Building codes and regulations add costs to school construction, resulting in significantly higher prices. Regulations including the Field Act and the prevailing wage law and the multitude of other regulations significantly increase the cost of school construction. The legislature should streamline school construction regulations and work to repeal regulations that raise costs but have little justification in terms of student safety or building integrity.

G. Reform Higher Education Capital Outlay Process

California needs to rethink its approach to funding higher education facilities.

The higher education system has had a somewhat predictable need for facilities that will continue to grow as school enrollment increases. Rather than paying double for higher education school facilities through general obligation bonds, the legislature should fund college school facilities as much as possible from fees and general revenue on a pay as you go basis, reserving costly bonds as a last resort. College facilities should be considered a critical budget item for California. Currently in California only \$192 million in capital outlay projects come directly out of the general revenue budget.

California should also incorporate a school facility user fee into the cost of school tuition to help offset the costs of higher education facilities.

In addition, the UC system should be required to pay for some of its research facilities costs out of research revenue. According to the Legislative Analyst's Office UC has a large revenue source in the facilities and administration overhead it charges sponsors of faculty research. Most of this revenue comes from the federal government and private for- and not-for-profit entities. This annual revenue has increased steadily for the past 20 years and is now around \$3 billion, of which about 55 percent is from the federal government.

About 13 percent or roughly \$390 million of the annual research revenue is provided specifically to cover the facilities costs associated with the research.

The Legislative Analyst offers two options for utilizing UC's research income. One option is to increase UC's share in the cost of their capital improvement program by more fully using research overhead funds that are available for capital outlay purposes. UC could finance the research space up front by selling bonds backed by a pledge of the overhead revenue. This method would reduce the state's upfront appropriation of bond funds. An alternative would have the state finance the project cost using its bonds, with UC pledging to the state the overhead revenue to pay the annual general fund debt payment costs for the associated research space. Under either method, assuming a 25-year bond repayment period for the four projects, UC would have an annual payment of about \$17.5 million. This is less than 5 percent of the annual overhead revenue available for capital outlay. In turn, the state would realize a reduction in its annual general fund debt payments.

Finally, the higher education system should be required to fully utilize its existing facilities before building more classrooms. The Legislative Analyst's Office argues that in higher education, more extensive use of year-round education would accommodate a lot of new enrollment without any additional capital costs. The California State University system currently is at 9 percent of capacity in the summer, while the University of California (UC) is at about 20 percent. In addition, the majority of classrooms in the higher education system are not fully utilized during the regular academic year.

H. Utilize Private Delivery of New Schools

The current general obligation bond approach to funding facilities does not offer school districts incentives to take advantage of innovative public-private partnerships for new schools.

California needs alternative school facilities financing mechanisms that build schools quickly—on time and on budget.

Lease-Leaseback

The lease-leaseback method is a public-private partnership where a school district purchases land and leases it to a developer for at least \$1 per year. The developer then finances construction of the school and subsequently leases the facility back to the school district over a period of time. This greatly reduces costs because it avoids the timely bid-build school construction process in which projects are often millions over budget. In this lease-leaseback process the developer assumes the risk and manages the cost and has every incentive to build schools quickly. By using private delivery of financing and construction, lease-leaseback agreements reduce bureaucracy and lead to better facilities. Because projects are initially paid for by the developer, districts can stretch construction dollars. If schools were funded at the local level through a combination of a state per-pupil facility grant, developer fees, and local bonds, this combination of diverse revenue could be used to pay for schools through a lease-leaseback methodology. Since the developer would also be the funding source for the project, the district could pay for schools over time at the local level and still have the advantage of having the school built quickly. In Sacramento, Inderkum High was completed a month early and \$2.5 million under budget under lease-leaseback. San Marcos Unified used the lease-leaseback method to build Mission Hills High School for \$73.5 million, and Fallbrook Union Elementary used it for three modernization projects worth \$13 million.

Developer-Built Schools

Developer-built schools are a booming new trend in California. For developers building major new neighborhoods that create a need for one or more new schools, building the schools themselves and turning them over to the school district to run lets them build schools that are a keystone of the neighborhood.

Typically the developer partners with the school district to design the school and then builds it for the school district to operate. The school district provides the impact fees the developer has paid under SB 50 and the developer puts up whatever additional funds are needed to build the school they want as a central amenity of the new development.

For example, Junction Elementary in the Roseville City School District is the Sacramento region's first school built entirely by a developer. Junction Elementary was built ahead of schedule and saved \$4 million from the school's nearly \$25 million price.

Developer-built schools are an emerging strategy in providing education facilities where the homebuilder fronts the money and constructs the campus. School officials and developers say this approach saves time and possibly millions of dollars in construction costs, which continue to rise as the price of building materials soars. It also takes the financial burden off cash-strapped school districts. Ten developer-built schools are scheduled to open in California this year, and another 47 are being planned and designed.

California should follow the lead of the United Kingdom and other European countries that have solved their school construction crises through large-scale public-private partnership models. In 1997 before the United Kingdom's Private Finance Initiative (PFI) the UK's backlog of schools was estimated at £7 billion. Under PFI, a Local Education Authority (LEA) can enter a 25-30 year contract with a private developer to design, build, finance, and partially operate schools in its jurisdiction. The developer consortium retains ownership of school; the school makes regular payments for use of the facility; payment deductions apply if private developer does not meet standards outlined in contract.

More than 500 primary and secondary schools in England have been built through the PFI since 1998.

In the United States we have done PFI-type experiments on a case by case basis.

- Oyster Elementary: District of Columbia Public Schools partnered with LCOR to build a new school at no cost to taxpayers; the developer meets debt obligation with revenue from an adjacent apartment complex built on land provided by the school district.
- Gilbane Properties built two high schools for the Houston Independent School District – completed a year early and for \$20 million less than traditional public procurement projections.
- Everett Dowling's development of Kamali'i Elementary was completed four months early with savings of at least \$2 million; Dowling now proposes development of a Maui high school on a 30-year lease-to-buy basis.
- In Niagara Falls, N.Y., Honeywell Inc. built an \$83 million school for the city to lease, allowing the city to avoid any tax increases or debt. Honeywell was able to erect the school for \$15 million less than it would have cost the school district.

Public-private partnerships can play an important role in the development of new schools in California. Because the private builder assumes the risk of building a new school and has real money to lose because of construction delays, the developer has an incentive to build schools quickly at or under budget. Local school districts should be encouraged through financial incentives to utilize innovative school partnerships. Since the developer finances the school up-front school districts or the state can redirect school construction bond money to more efficiently modernize and build new schools.

Part 5

Conclusion

Many California children continue to languish in deteriorating and overcrowded classrooms in spite of the fact that in the past decade California has made a massive \$95 billion investment in K-12 and higher education infrastructure. Proposition 1D would continue this trend with another \$10.4 billion education bond. Yet, the proposition offers no help for the school children who are stuck with deteriorating schools, not because of a lack of funding, but because of the highly-regulated school construction process and the mismanagement of school district facility programs. It is time to revamp the school construction process in California. Regulations should be streamlined, local districts should take the primary responsibility for their school facilities needs, the districts should utilize the cost saving benefits of public-private partnerships, and the work should be performance-based to ensure that school districts build schools on time and on budget.

About the Author

Lisa Snell is director of the Education Program at Reason Foundation where she oversees Reason Foundation's research on social services and education issues. Her most recent policy studies include *Special Education Accountability: Structural Reform to Help Charter Schools Make the Grade* and *Child Advocacy Centers: One-Stop on the Road to Performance-based Child Protection*. Ms. Snell frequently comments on education issues on radio and television media including recent appearances on the Fox News Channel, ABC's "Wall Street Journal Report," and numerous regional news programs. Ms. Snell has published numerous articles and op-eds on school choice in newspapers including the *Las Vegas Review Journal*, *Orange County Register*, and the *Los Angeles Daily News* and frequently speaks about this issue. She is a frequent contributor to *Reason* magazine and a monthly columnist for Reason Foundation's *Privatization Watch*. Before joining Reason, Ms. Snell taught public speaking and argumentation courses at California State University, Fullerton. She was also a recipient of the 1994 Charles G. Koch Fellowship and worked on public policy issues for the Institute for Justice and *Reason* magazine.

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