

Department of Legislative Services
 Maryland General Assembly
 2012 Session

FISCAL AND POLICY NOTE

House Bill 1803 (The Speaker)(By Request - Administration)
 Appropriations

Creation of a State Debt - Qualified Zone Academy Bonds

This Administration bill replaces SB 153 of 2012, which did not meet requirements for constitutionality. It authorizes the Board of Public Works to issue \$15,324,000 in interest-free Qualified Zone Academy Bonds (QZABs) by December 31, 2012, and grant the proceeds to the Interagency Committee on School Construction (IAC) and the Maryland State Department of Education (MSDE) for the renovation, repair, and capital improvements of qualified zone academies, including public charter schools, as defined in the federal Internal Revenue Code. Proceeds from the sale of QZABs must be spent no later than three years after the issuance of the bonds. The bill also validates similar QZAB authorizations enacted in 2010 and 2011 that were passed by the General Assembly prior to the passage of the State operating budget in each respective year.

The bill takes effect June 1, 2012.

Fiscal Summary

State Effect: Bond revenues and expenditures increase by \$15.3 million in FY 2013 from the issuance of QZABs. Annuity Bond Fund expenditures increase by an estimated \$510,800 in FY 2013 and then by \$1.02 million for 14 years, with one additional payment of \$510,800 in the sixteenth year to pay off the principal on the QZABs. Special fund expenditures by the Public School Construction Program increase by \$48,800 in FY 2013 and \$46,800 in FY 2014 to continue employment of a contractual QZAB program manager through FY 2014. The validation of prior QZAB authorizations has no effect on State finances.

(in dollars)	FY 2013	FY 2014	FY 2015	FY 2016	FY 2017
Bond Rev.	\$15,324,000	\$0	\$0	\$0	\$0
SF Expenditure	\$559,600	\$1,068,400	\$1,021,600	\$1,021,600	\$1,021,600
Bond Exp.	\$15,324,000	\$0	\$0	\$0	\$0
Net Effect	(\$559,600)	(\$1,068,400)	(\$1,021,600)	(\$1,021,600)	(\$1,021,600)

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate effect

Local Effect: Local school revenues for school renovation increase by \$15.3 million in FY 2013 from the distribution of QZAB proceeds.

Small Business Effect: The Administration determined that SB 153 of 2012 would have had a meaningful impact on small business (attached). Legislative Services concurs with this assessment and advises that the assessment for SB 153 also applies to this bill.

Analysis

Bill Summary: IAC and MSDE may use QZAB proceeds provided by the Board of Public Works for the following purposes, in accordance with criteria established under the Aging Schools Program:

1. for competitively awarded grants by IAC to eligible school systems for qualified academies, including public charter schools; and
2. for targeted grants awarded by MSDE to eligible school systems for qualified academies, including public charter schools, under the Breakthrough Center Program.

Current Law:

QZABs

The federal Tax Reform Act of 1997 created QZABs as a new type of debt instrument to finance education projects. Financial institutions, insurance companies, and investment houses are the only entities allowed to purchase the bonds, which provide for a federal tax credit instead of interest earnings. The program has been extended several times, most recently under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, which included \$400 million of additional QZAB authorization. Under current federal guidelines, QZAB funds may be used only to rehabilitate or repair school facilities, provide equipment, develop course materials, or train teachers and other school personnel; they may not be used for new construction. They can be used only for qualified zone academies, which are defined as public schools that (1) are designed in cooperation with business to enhance the academic curriculum, increase graduation and employment rates, and prepare students for college and the workforce; and (2) require students to meet the same academic standards and assessments as other students in the same school system. Qualified zone academies must either be located in a federal Enterprise or Empowerment Zone or have at least 35% of their student population qualify for free or reduced price meals.

Maryland has allowed QZAB proceeds to be used only for renovation and repair (brick-and-mortar) projects as part of the Aging Schools Program administered by IAC. However, Chapter 707 of 2009 expanded the use of *previously* authorized QZABs to include equipment, which is an authorized use under Section 1397E (revised and recodified as Section 54E by the federal Tax Extenders and Alternative Minimum Tax Relief Act of 2008) of the Internal Revenue Code. Chapter 707 also authorized MSDE to allocate QZAB funds to local education agencies. QZABs are issued with the full faith and credit of the State. Therefore, QZABs are considered State debt. For purposes of calculating State debt affordability, QZABs are included in the State's general obligation bond debt outstanding and debt service.

Chapter 96 of 2011 first authorized the use of QZABs for public charter schools.

Supplementary Appropriations

The Executive Budget Amendment to the Maryland Constitution allows either house of the General Assembly to consider appropriation measures in addition to the State operating budget but requires that final action on any such supplementary appropriations comes after passage of the budget bill. The State's capital budget, bond bills, and other similar measures (including QZAB authorizations) are all considered supplementary appropriations subject to the constitutional requirement because they require the State to impose the State property tax in order to generate revenues to cover the debt service payments on the authorized and subsequently issued debt.

In general, the constitutional requirement that passage of supplementary appropriations await passage of the budget bill prevails over any other provisions of the Constitution in the event of an inconsistency. However, the Executive Budget Amendment also contains language that none of its requirements may affect the State's obligations regarding the collection of taxes to pay debt service or on the State's obligation to pay debt service on prior issuances of debt.

Background:

QZABs

Maryland first authorized the sale of QZABs in Chapter 322 of 2000. Additional issuances were authorized by Chapter 139 of 2001, Chapter 55 of 2003, Chapter 431 of 2005, Chapter 585 of 2007, Chapter 523 of 2010, and Chapter 96 of 2011.

Federal law requires that QZAB projects receive a 10% private-sector match, which may be in the form of cash, in-kind goods such as equipment or technology, services such as help developing curriculum, and internships or field trips. While Maryland law

authorizes QZABs to be spent on brick-and-mortar projects and, for some previously authorized QZABs, equipment, federal law also allows spending on curriculum development and training for teachers and other school personnel.

Maryland has two federal QZAB allocations that have not been issued. In 2011, Maryland's allocation is \$15.3 million, and bonds for these funds must be issued by December 31, 2012; this bill authorizes bond sales for that allocation. In 2012, the QZAB allocation is \$4.5 million, and the bonds must be sold by December 31, 2013.

To date, Maryland's allocation under the federal program has totaled \$67.9 million from seven prior-year bills that authorized the sale of the bonds; however, including interest earned on QZAB proceeds brings total proceeds for the State to \$70.7 million, as shown in **Exhibit 1**. Omitting the most recent sale, which was completed in August 2011, 83.1% of QZAB proceeds had been spent as of December 31, 2011.

Even though more than three-quarters of the QZAB proceeds have been spent, a small number of local school systems have poor track records in spending their allocations. The large unexpended balances in a few jurisdictions prompted IAC to propose, beginning with the 2011 sale of QZABs, awarding QZAB funds using a competitive grant process instead of relying on the Aging Schools Program's formula.

Exhibit 1
QZAB Proceeds and Expenditures as of December 31, 2011

Year of Sale	Proceeds	Interest Income	Proceeds + Interest	Expenditures	Unexpended Balance	% Expended
2001	\$18,098,000	\$1,321,097	\$19,419,097	\$19,362,352	\$56,745	99.7%
2004	9,043,000	944,934	9,987,934	8,257,866	1,730,068	82.7%
2006	4,378,000	326,348	4,704,348	3,769,503	934,845	80.1%
2007	4,986,000	128,408	5,114,408	3,342,703	1,771,704	65.4%
2008	5,563,000	0	5,563,000	5,563,000	0	100.0%
2009	5,563,000	11,366	5,574,366	3,950,337	1,624,028	70.9%
2010	4,543,000	7,563	4,550,563	1,372,688	3,177,875	30.2%
2011	15,731,348	8,274	15,739,622	0	15,739,622	0.00%
Total	\$67,905,348	\$2,747,990	\$70,653,338	\$45,618,450	\$25,034,888	

Note: In anticipation of closing the 2008 QZAB account, the interest balance for 2008 is reflected in the Proceeds column.

Source: Interagency Committee on School Construction

Aging Schools Program

The Aging Schools Program was initially established by the 1997 Baltimore City-State Partnership legislation, which provided \$4.4 million for the program and specific allocations for local school systems. The following year, the School Accountability Funding for Excellence legislation increased the annual funding level by \$6.0 million to \$10.4 million. In both Acts, the Aging Schools Program was scheduled to terminate after fiscal 2002; however, the date was later altered to give the Task Force to Study Public School Facilities time to consider maintaining or changing the program.

In response to task force recommendations, bills were enacted in 2003 and 2004 to eliminate the termination date on the Aging Schools Program and reallocate program funds to more closely reflect the statewide distribution of older school buildings. The statutory allocations are based on each county's share of statewide pre-1970 square footage. In addition, the 2004 capital budget bill (Chapter 432) included General Assembly intent language to add fiscal 2006, 2007, and 2008 "hold harmless" funding to the statutory grant levels in order to lessen the impact of the reallocation recommended by the task force and enacted in Chapters 306 and 307 of 2004. Chapter 252 of 2006 added an annual inflationary adjustment to the Aging Schools Program beginning in fiscal 2008. The Budget Reconciliation and Financing Act (BRFA) of 2009 (Chapter 487) "rebased" the program at \$6.1 million in fiscal 2010 and 2011, with the program returning to its base funding level of \$10.37 million in fiscal 2012 and inflationary adjustments set to return in fiscal 2013. The 2010 BRFA (Chapter 484) permanently rebased the program at \$6.1 million with no annual adjustment, except that a one-time increase of \$2.5 million was allocated to the program in the fiscal 2012 capital budget. Under the proposed 2012 BRFA (SB 1301/HB 1801), total program funding will revert to \$6.1 million annually beginning in fiscal 2013. However, the fiscal 2013 capital budget includes a one-time increase of \$25.0 million for the Aging Schools Program.

Eligible Aging Schools Program expenditures include asbestos and lead paint abatement; upgrade of fire protection systems and equipment; painting; plumbing; roofing; upgrade of heating, ventilation, and air conditioning systems; site redevelopment; wiring schools for technology; and renovation projects related to education programs and services. Projects must cost at least \$10,000 to be funded through the program. MSDE and the Public School Construction Program review aging schools project requests submitted by local school systems, approve eligible projects, and determine if additional review of any construction documents will be required.

Breakthrough Center

The Breakthrough Center's primary focus is to efficiently coordinate MSDE's resources for 16 schools and their 20 feeder schools in Baltimore City and Prince George's

County. Without the center, schools and districts have to work with different MSDE divisions to access different resources. Furthermore, the Breakthrough Center coordinates resources from government and private-sector partners and provides funding for supplemental instructional support, such as job-embedded professional development for teachers. To provide long-term support, the Breakthrough Center develops multi-year memoranda of understanding signed by the participating schools, districts, and MSDE that specify the roles and responsibilities of each.

While the center's focus is on low-performing schools, it is launching voluntary statewide initiatives and will offer webinars and e-learning communities, all centered on what works in school improvement. The center plans to develop evaluation mechanisms, and the results will be an important measure of MSDE's targeted assistance. The center's pilot phase was completed in summer 2010, and full operation began in fiscal 2011. A portion of the previously authorized QZABs, approximately \$2.9 million, was allocated through the Breakthrough Center to eligible schools with MSDE helping to identify corporate opportunities to raise the 10% match. The State budget for fiscal 2012 includes \$1.1 million from federal Race to the Top funds for the center. IAC is working with MSDE to identify large projects in schools that are targeted for intervention by the Breakthrough Center so that eligible capital costs associated with the improvement efforts can be funded with QZAB proceeds. Therefore, in addition to the competitive grant process described above, a portion of the QZAB proceeds will be distributed to schools being assisted by the Breakthrough Center.

Public Charter Schools

Public charter schools are public schools that provide alternative approaches to learning to improve student academic performance. They operate under the supervision of a local board of education or the State Board of Education and, with certain exceptions, in accordance with the laws and regulations that govern other public schools. Local school boards must give public charter schools a per-student amount of county, State, and federal money that is commensurate to the amount given to other public schools in the same jurisdiction. The State Board of Education or a local board may give surplus educational materials, supplies, furniture, and other equipment to a public charter school. Public charter schools do not receive a specific allocation for capital facilities.

There are currently 50 public charter schools in the State: 38 in Baltimore City; 7 in Prince George's County; 2 in Anne Arundel County; and 1 each in Baltimore, Frederick, and St. Mary's counties. Many public charter schools are located in former public school buildings, especially in Baltimore City. Some public charter schools lease space in private buildings. Under the bill, any public charter school in Maryland could be eligible to receive QZAB funds if it meets the qualifications.

QZAB Authorizations

In conducting its standard review of legislation passed by the General Assembly during the 2012 session, the Office of the Attorney General (OAG) determined that final passage of SB 153, which authorized the sale of QZABs, came before final passage of the budget bill. As a result, the Attorney General has recommended that the Governor veto the bill and that the General Assembly reconsider the authorization during the special session to ensure compliance with constitutional requirements.

OAG also determined that passage of QZAB authorizations enacted in 2010 and 2011 (Chapters 523 and 96, respectively) occurred prior to the passage of the respective budget bills. Although the constitutional requirement that they await passage of the budget bill cannot impede the State's obligations under those authorizations for which debt has already been issued, OAG recommended that the new QZAB bill ratify the two prior authorizations. Therefore, this bill affirms the validity of Chapters 523 and 96 as authorizations of State debt and obligations of the State.

State Fiscal Effect: Bond revenues and expenditures increase by up to \$15.3 million in fiscal 2013 from the issuance of QZABs, with the funding distributed to local school systems, either through competitive grants or the Breakthrough Center, for eligible school renovation and repair projects, including public charter schools. The State is required to repay the principal on the bonds within 15 years after the date of issuance. As QZABs are tax-credit bonds, the State is responsible for repaying only the principal. However, federal arbitrage rules prohibit the State from earning interest on the proceeds of tax-credit bonds. Therefore, debt service payments consist of annual payments of \$1.02 million into the Annuity Bond Fund with the intent of paying off the full \$15.3 million at the end of the 15-year period. However, in fiscal 2013, only one of two annual payments is made, due to the timing of the sale of the bonds, so fiscal 2013 Annuity Bond Fund expenditures are only \$510,800. When the Annuity Bond Fund is unable to fully fund the debt service on bonds issued by the State, general funds are used to pay the remaining amount. Neither the fiscal 2012 budget nor the fiscal 2013 State budget includes general funds to supplement annuity bond funds.

With the exception of the 2010 allocation, the QZAB allocation authorized by this bill is more than three times larger than the most recent allocations, and the distribution of funds through a competitive grant process requires significantly more staff time by IAC than the formula-based distribution of past allocations. Also, the process of monitoring project status and ensuring that projects will expend all funds within the three-year timeframe required by the last three QZAB allocations has proven to be very intensive, as reflected by the large unspent allocations in several jurisdictions.

In February 2011, IAC received approval of a \$23,000 special fund budget amendment to hire a contractual position to manage the QZAB program for one year. The special funds are available from QZAB issuances prior to 2008, of which federal law allows up to 5% to be used for administrative costs. The increase in the size of the 2010 QZAB allocation prompted IAC to retain the contractual position through fiscal 2012 at an approximate cost of \$47,000. To enable IAC to continue to carry out the administrative and oversight functions for the 2011 QZAB allocation, special fund expenditures increase by \$48,842 in fiscal 2013, which provides for the continuation of the QZAB manager through fiscal 2013 and 2014. This estimate reflects the cost of maintaining a contractual QZAB program manager to oversee the distribution of the QZAB proceeds and monitor project status and assumes that the QZAB manager ends employment in June 2014. It includes a salary, fringe benefits, and ongoing operating expenses.

Contractual Position	1.0
Salary and Fringe Benefits	\$48,292
Operating Expenses	<u>550</u>
Total FY 2013 State Expenditures	\$48,842

Local Fiscal Effect: Local school revenues for public school renovation and repair increase by up to \$15.3 million in fiscal 2013. Distribution of the QZAB proceeds among local school systems will be determined by a competitive grant process administered by IAC and also by the Breakthrough Center. There is no local match for QZABs, although local school systems must raise private entity matches equal to 10% of their QZAB distributions in order to receive the QZAB funds.

Additional Information

Prior Introductions: None.

Cross File: SB 1303 (The President)(By Request - Administration) - Budget and Taxation.

Information Source(s): Board of Public Works, Maryland State Department of Education, Department of General Services, Public School Construction Program, Office of the Attorney General, Department of Legislative Services

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ANALYSIS OF ECONOMIC IMPACT ON SMALL BUSINESSES

TITLE OF BILL: Creation of a State Debt – Qualified Zone Academy Bond

BILL NUMBER: SB 153

PREPARED BY: Kwame Kwakye, Department of Budget and Management

PART A. ECONOMIC IMPACT RATING

This agency estimates that the proposed bill:

WILL HAVE MINIMAL OR NO ECONOMIC IMPACT ON MARYLAND SMALL BUSINESS

OR

WILL HAVE MEANINGFUL ECONOMIC IMPACT ON MARYLAND SMALL BUSINESSES

PART B. ECONOMIC IMPACT ANALYSIS

Yes. The legislation may create additional contracting opportunities for small businesses. Based on historical data, the average value of a QZAB project is \$118,000. The FY 2013 projects are likely to be generally consistent with the historical average of \$118,000.