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How State Credit Enhancement of School District Debt Is a Virtually No-Cost Policy for Bridging the School Infrastructure Gap

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In many parts of the country, the K-12 education system faces an infrastructure challenge. School districts serving low-income areas spend less on average than those serving affluent neighborhoods. Some schools are in dire need of facility repair and upgrades. States may provide loans and grants for such school capital projects, but they require states to commit their scarce budget resources.

One potential solution is a state credit enhancement program, a government initiative designed to improve the creditworthiness of certain projects or entities within the state. These programs typically involve the state government providing guarantees or other forms of financial backing to reduce the risk for lenders. In short, a state legislature enacts a credit enhancement program that promises to repay qualified school debt when a district cannot do so. With this promise, school districts can achieve lower interest rates when borrowing money to finance a capital project and thus can fund more capital projects. Besides the small administrative cost of running the program, the state does not need to allocate any funding upfront. As school districts rarely default on their debt, the long-run risk is low.

The Problem

Capital projects, such as school building construction, equipment purchases, and bus acquisition, typically involve significant one-time expenditures. To pay for the upfront cost, districts often borrow money from investors by issuing bonds on the municipal bond market. Bond market data shows that, on average, districts serving communities with higher levels of poverty face higher costs to borrow.

Understandably, higher borrowing costs often correspond to lower levels of capital spending. Therefore, if we could reduce interest rates charged by the bond market to school districts, we may be able to increase investment in educational infrastructure. Similarly, if the interest rates paid by high-poverty districts could be brought down to the rates paid by low-poverty districts, we may narrow the infrastructure gap across school districts.

The Solution

Currently, 24 states have credit enhancement programs for school debt. State credit enhancement is a pledge by the state to take certain actions, such as intercepting state aid or temporarily using state funds to pay the interest or principal on school bonds if a district is unable to do so. With state credit enhancement, a district receives an enhanced credit rating, which is largely benchmarked to the state's own credit rating. Because low-

income districts are more likely to have low credit ratings, state enhancement is most attractive to them. This is essentially a method that states can use to lower districts' borrowing costs without directly spending money, as it is analogous to a parent co-signing on a loan for a child.

Data show that the state credit enhancement reduces the average district's interest rate by six percent and the reduction is larger for higher-poverty districts. On average, capital spending increases by six to seven percent because of state enhancement and the increase is also larger for high-poverty districts. In sum, the empirical evidence suggests that state credit enhancement has the potential to offer significant interest savings to school districts and spur additional education infrastructure investment, with minimal costs to the state government.

Policy Actions and Considerations

States without a credit enhancement program should first assess if such a program has the potential to bring cost savings to school districts. For a state to provide meaningful credit enhancement, the state government must have a sufficiently strong credit rating that is higher than the ratings of bond-issuing districts within the state.

Second, the state needs to decide which resources should be committed to repaying a school bond, in the rare event that a default is about to occur. States may intercept aid that is going to the school district, use it for bond repayment, and require the district to repay the state later. This commits no state resources and poses the least amount of financial risk to the state government. However, its potential to reduce interest rates paid by school districts is the lowest among all options. On the other hand, the state may commit general revenue to repay a near-default school bond. This approach can achieve large borrowing cost savings for school districts but also forces the state to open its pocketbook when a district fails to repay a bond.

Moreover, the state must decide which types of debt are eligible for enhancement, for example, whether the enhancement should be limited to debt issued by independent school districts or any local government debt for educational purposes.

To avoid the moral hazard problem that districts borrow recklessly as the state serves as the backup payer, a state can adopt several risk-control measures. A majority of the 24 states offering credit enhancement limit it to only general obligation school bonds backed by district general revenue but not revenue bonds repaid with specific revenue sources such as sales taxes or charges. Many programs also require approval by the state for each bond issuance and charge a nominal fee.

State credit enhancement programs represent a promising strategy to alleviate the infrastructure disparities in K-12 education without imposing significant costs on state budgets. By enhancing the creditworthiness of school districts, these programs effectively lower borrowing costs and stimulate capital investment in educational infrastructure. This approach not only addresses the pressing needs of schools in low-income areas but also demonstrates a prudent use of state resources to foster equitable access to quality education facilities across diverse communities