



The 2014-15 Budget:

Changes to a Local Infrastructure Financing Tool

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SUMMARY

In 1990, the Legislature authorized cities and counties to form infrastructure financing districts (IFDs) to fund local infrastructure projects. Since then, cities and counties rarely have used IFDs. Instead, they have opted to use alternative methods to fund infrastructure, including redevelopment agency (RDA) funds. The dissolution of RDAs in 2011 has prompted calls for a review of the financing tools available to local governments to fund infrastructure and local economic development.

The Governor's 2014-15 budget proposes several changes to IFDs which are intended to provide local governments with enhanced options to fund infrastructure and local economic development, as well as various other types of initiatives, such as urban infill, transit-oriented development, and affordable housing.

Some components of the Governor's proposal merit consideration. Particularly, the proposed expansion of IFD activities could further some state and local objectives, such as reducing greenhouse gas (GHG) emissions, increasing the supply of affordable housing, and mitigating environmental pollution. Thus, with one exception which we discuss in the report, we recommend the Legislature adopt the Governor's proposed expansion of IFD activities.

Other components of the Governor's proposal raise concerns. Most notably, the Governor's proposal to lower the voter-approval threshold for IFD debt may conflict with provisions of the State Constitution requiring voter approval of city and county debt. In addition, the Governor proposes to maintain somewhat problematic rules related to voter approval of IFDs. Therefore, we recommend the Legislature reject the Governor's proposed changes to the voter-approval requirements for IFDs. Instead, we suggest the Legislature consider two alternatives: (1) restructure IFDs to resemble similar types of local entities that do not have voter-approval requirements or (2) expand voter-approval requirements to allow all residents of the communities affected by an IFD to vote.

INTRODUCTION

The Governor’s budget proposes several changes to a seldom used infrastructure financing tool for local governments, known as IFDs. These changes are intended to provide local governments with enhanced options to fund infrastructure and local economic development, as well as various

other types of initiatives, such as urban infill, transit-oriented development, and affordable housing. This report (1) describes the Governor’s proposal, (2) comments on various aspects of the proposal, and (3) offers recommendations for the Legislature to consider.

BACKGROUND

Local Government Finance

Property Taxes Are Allocated to Local Governments. Californians pay around \$50 billion in property taxes annually. County auditors distribute these revenues to local governments—schools, community colleges, counties, cities, and special districts—pursuant to state law. The share of property tax revenues allocated to each type of local government varies from location to location. Each local government’s share of property tax revenue reflects, in part, the share it received in the mid-1970s.

Property Taxes Contribute Toward Meeting the State’s Education Funding Obligation. School and community college districts receive a certain level of general purpose per-pupil funding, as specified in the annual budget act. School districts receive this funding from a combination of local property tax revenues and state General Fund revenues, while community college districts receive funding from local property taxes, student fees, and state General Fund revenues. If a school or community college district’s local property tax revenue (and student fee revenue in the case of community colleges) is insufficient to fund the authorized per-pupil rates, the state provides General Fund revenues to meet the statutory requirements. Conversely, if a district’s nonstate

resources alone exceed the per-pupil rates, the district does not receive general purpose state aid.

State Constitution Limits Local Government Debt. The State Constitution prohibits cities, counties, and schools from issuing new long-term debt without obtaining approval from two-thirds of local voters. It is important to note, however, that various types of long-term obligations commonly incurred by local governments—such as lease-revenue bonds, certificates of participation, pension obligation bonds, and pension liabilities and other retiree benefits—have not been held to be subject to these requirements.

Infrastructure Financing Districts

Use Tax Increment Financing to Fund Infrastructure Projects. In 1990, the Legislature authorized cities and counties to form IFDs to fund infrastructure projects. Once formed, an IFD receives a portion of property tax growth within the district—known as “tax increment”—to fund specified infrastructure projects. IFDs may pay the cost of infrastructure projects directly with tax increment or may issue bonds that are repaid with the tax increment. State law does not authorize IFDs to levy new taxes. Local government use of IFDs has been uncommon, with only a small number of districts formed since 1990.

Fund Infrastructure of Communitywide

Significance. IFDs may finance the construction, improvement, or rehabilitation of various types of public facilities of “communitywide significance,” including: highways, streets, roads, sewage and water treatment facilities, flood control, child care facilities, libraries, parks, and solid waste disposal facilities. The public facilities must provide significant benefits to an area larger than the district’s boundaries. IFDs may not pay the cost of maintenance or operation of public facilities.

Receive Tax Increment Only From Consenting Local Governments. A city or county that forms an IFD may dedicate to the IFD all or some of the property tax increment it would receive from properties within the district. Other noneducation local governments whose jurisdictions overlap with the IFD also may elect to dedicate all or some of their property tax increment to the IFD. However, tax increment may not be shifted from other local governments without their approval. In addition, tax increment may not be shifted from school or community college districts to an IFD. As a result, the formation of an IFD has no fiscal effect on the state. IFDs may receive property tax increment for up to 30 years.

Do Not Have a Separate Governing Body.

IFDs do not have separate governing bodies. Rather, the governing body of the city or county that forms an IFD governs the district’s activities, including the issuance of debt.

Require Voter Approval. State statute requires the formation of an IFD to be approved by two-thirds of voters living within the district. Additionally, two-thirds of voters living within the district must approve the issuance of long-term debt by the IFD. If fewer than 12 registered voters live within the district, then two-thirds of landowners within the district must approve these actions.

May Be Subject to Constitutional Vote

Requirements. In addition to statutory voter-approval requirements, IFD debt may be subject to provisions of the State Constitution requiring voter approval of local government debt. As mentioned above, the State Constitution requires cities and counties to obtain approval from two-thirds of their voters prior to issuing long-term debt. Because existing state law does not distinguish IFDs as a legal entity separate from their sponsoring cities or counties, the two-thirds voter-approval requirement of a city and county may extend to its IFD.

Other Local Government Financing Tools

While local governments have used IFDs infrequently, they historically have used two similar methods of funding infrastructure and economic development more regularly.

- **Redevelopment Agencies.** For several decades, state law authorized cities and counties to form RDAs to address urban blight and affordable housing needs. As discussed in more detail in the next section, legislation was enacted in 2011 dissolving RDAs. Similar to IFDs, RDA activities were funded primarily from property tax increment.
- **Joint Powers Authorities.** State law authorizes local governments to form separate legal entities called joint powers authorities (JPAs) to facilitate the pooling of resources—including tax revenues—from multiple governments to address a common concern or fund projects or services. JPAs may finance projects by issuing long-term debt that is repaid from payments from constituent local governments.

Over the last few decades, JPAs and RDAs issued tens of billions of dollars of long-term debt to fund infrastructure and economic development. Unlike IFDs, JPA governing bodies can issue long-term debt without obtaining voter approval. Similarly, state law did not require RDA governing bodies to obtain voter approval prior to issuing long-term debt. The governing bodies of JPAs and RDAs are (or were) legally separate from the governing bodies of their sponsoring local governments.

Elimination of Redevelopment

Legislation Enacted Ending Redevelopment. Chapter 5, Statutes of 2011 (ABX1 26, Blumenfield), enacted in June 2011, dissolved RDAs, effective October 1, 2011, and created a process for winding down redevelopment financial affairs and distributing any net funds from assets or property taxes to other local taxing agencies. (Court actions changed the date of RDA dissolution to February 1, 2012.)

Former RDA Resources Are Distributed to Affected Local Governments. As the operations of former RDAs wind down, their resources are being redistributed to other local governments. These resources include (1) property tax revenue not needed to pay RDA debts and pass-through

payments to local governments, (2) unencumbered RDA cash and other liquid assets, and (3) proceeds from the sale of some former RDA real estate holdings.

State Controller Tasked With Recovering Assets Transferred to Other Entities. Prior to dissolution, many RDAs took actions to transfer redevelopment assets—land, buildings, parking facilities—to other local agencies, typically the city or county that created the RDA. Assembly Bill X1 26 assigns the State Controller (SCO) responsibility for recouping redevelopment assets inappropriately transferred during the first half of 2011. Specifically, SCO is directed to determine whether the RDA transferred an asset to the city or county that created it (or to another public agency). If the asset has not been contractually committed to a third party, “the Controller shall order the available asset to be returned” to the successor agency.

Dissolution Prompted a Significant Amount of Litigation. Over 180 lawsuits have been filed against the state regarding various aspects of the redevelopment dissolution process. Most of these lawsuits concern whether or not certain former RDA obligations are eligible to be repaid from former RDA property tax revenue.

GOVERNOR’S PROPOSAL

The Governor’s budget proposes to make several statutory changes related to IFDs. We describe these changes below.

Expands the Scope of IFDs. The Governor proposes to expand the scope of projects IFDs may fund. Specifically, the Governor proposes to allow IFDs to fund: (1) housing, retail, and manufacturing facilities (retail facilities, however, generally are limited to 30,000 square feet and grocers generally

are limited to 60,000 square feet); (2) property development designed to meet sustainable communities goals established in Chapter 728, Statutes of 2008 (SB 375, Steinberg), such as transit priority projects; (3) restoration of brownfields—underused or abandoned sites contaminated by hazardous materials—and other environmental mitigation; (4) military bases reuse projects; and (5) telecommunications infrastructure. Under the

Governor’s proposal, these projects would not need to be publicly owned or operated.

Lowers IFD Voter-Approval Threshold. The Governor proposes to lower the voter-approval threshold for a city or county to form an IFD and issue IFD debt from two-thirds to 55 percent.

Creates New Stipulations for Creation of IFDs. Under the Governor’s proposal, a city or county that formerly sponsored an RDA must meet certain conditions related to redevelopment dissolution prior to forming an IFD. Specifically, a city or county must (1) resolve all outstanding RDA-related litigation against the state, (2) receive a “finding of completion” from the Department of Finance (DOF) signifying that all of their former RDA’s cash and liquid assets have been distributed to local governments, and (3) comply with any asset transfers ordered by the SCO.

Allows Local Governments to Loan Funds to IFDs. The Governor proposes to allow cities, counties, and special districts whose jurisdictions overlap with an IFD to loan funds to the IFD. The interest rate on these loans may not exceed the rate earned by investment in the Local Agency Investment Fund—a pooled investment fund administered by the State Treasurer.

Extends Timeline for IFDs. The Governor proposes to extend the amount of time property taxes may be diverted to IFDs to 45 years from the date of (1) issuance of IFD debt or (2) initiation of a loan between the IFD and a local government.

Requires IFD Audits. Under the Governor’s proposal, IFDs that issue bonds must conduct a financial and performance audit every two years. The audits would be required to meet guidelines developed by the SCO. In addition, the DOF could conduct financial and performance audits of IFDs.

ANALYSIS

Some Proposed Changes Have Merit

Proposed Expansion of IFD Activities Could Further Some State Policy Goals. . . . The proposed expansion of IFD activities could further some state and local objectives, such as reducing GHG emissions, increasing the supply of affordable housing, and mitigating environmental pollution. This is because cities and counties would have an additional tool to finance projects consistent with these objectives.

. . . But Scope of Activities Is Too Broad. The benefit to local governments taken together of funding development and expansion of retail facilities is less clear. New retail establishments can provide benefits—such as increased employment or local tax revenues—to the local governments in which they are located. These benefits, however, often are offset by losses to neighboring

communities where these establishments otherwise could have been located. As a result, the collective benefit to local governments of subsidizing the creation of new retail establishments typically is limited. Facilitating the development of retail facilities may be more likely to result in collective benefits in some cases. In particular, facilitating development of retail establishments as part of a targeted effort to promote dense, transit-oriented development could promote sustainable communities goals. The Governor’s proposal, however, would not limit IFD funding of retail facilities to these situations. Instead, the Governor’s proposal would allow IFDs to fund any moderately sized retail facility virtually anywhere in the state.

Permitting Loans From Affected Local Governments Could Be Helpful. Allowing affected local governments to loan funds to an IFD could facilitate local government use of IFDs. Doing so

might mitigate some barriers to forming an IFD, such as funding IFD startup costs.

Requiring Independent Audits of IFD Finances Seems Reasonable. The Governor's proposal to require IFDs that have issued bonds to obtain an independent financial and performance audits every two years seems reasonable. State law requires most special districts to obtain independent financial reports each year. In addition, state law requires school districts that have issued facilities bonds to obtain an annual performance audit in most cases.

Changes to Voter-Approval Requirements Raise Issues

What Is the Purpose of Voter-Approval Requirements for IFDs? In considering the Governor's proposed changes to voter-approval requirements for IFDs, it may be helpful to first consider a broader question: What is the purpose of these voter-approval requirements? In our view, requiring voter approval of IFDs could serve two purposes. Specifically, voter-approval requirements could ensure that local government decisions regarding IFDs are (1) aligned with their communities' interests and (2) subject to increased public scrutiny.

Align With Community Interests. Voter-approval requirements for IFDs could prevent local governments from forming an IFD or issuing IFD debt without the support of the community members who would be affected by these actions. Under current law, however, many residents who could be affected by IFD formation do not have the opportunity to vote on them. This is because the only residents who get to vote on IFDs are those living in the district. The decision of a local government to dedicate a portion of its revenue to an IFD affects all residents in the community. IFD projects are likely to be funded, in part, by redirecting local government revenues that

otherwise could be used to fund services for all of the local governments' residents. In addition, state law allows IFDs to fund projects that benefit residents living outside of district boundaries, including projects located outside of the district.

Ensure Increased Public Scrutiny. Voter-approval requirements also could ensure that the long-term commitment of a community's resources to an IFD is subject to heightened public scrutiny. It is unclear, however, why decisions related to IFDs necessitate increased public scrutiny while local governing bodies make similar decisions—such as forming a JPA and issuing JPA debt—without voter approval.

Is the Governor's Proposal Constitutional?

As discussed previously, the State Constitution requires cities and counties to obtain approval from two-thirds of their voters prior to issuing long-term debt. Because the Governor's proposal would not amend existing law in order to clearly distinguish IFDs as a legal entity separate from their sponsoring cities or counties, the constitution's two-thirds voter-approval requirement of a city and county may extend to its IFD. If so, implementing the Governor's proposal would require a constitutional amendment.

Other Proposed Changes Are Problematic

Creation of an IFD Does Not Interfere With RDA Dissolution. The Governor's proposed stipulations for the creation of an IFD seem inappropriate. The formation of an IFD would not interfere with local government efforts to dissolve former RDAs or with the resolution of RDA-related lawsuits against the state. While the administration and some local governments have significant disagreements regarding redevelopment dissolution, these disputes are not an appropriate reason to deny these local governments access to a financial tool designed to help them respond to local infrastructure and economic development needs.

DOF Authority to Audit IFDs Not Aligned With State Oversight Practices of Other Local Governments. The Governor’s proposal to allow the DOF to audit IFDs would create different financial review requirements for IFDs than for most other local governments. Specifically, state law requires most local governments to annually submit a

financial report to the SCO. The SCO is required to compile these financial reports in an annual publication. In addition, state law authorizes the SCO to initiate an investigation of a local government’s finances if it believes their reported financial information is false or incomplete.

LAO RECOMMENDATIONS

Adopt Most of the Proposed Expansion of IFD Activities. With one exception, we recommend the Legislature adopt the Governor’s proposed expansion of IFD activities. Specifically, we recommend rejecting the proposal to authorize IFDs to fund retail facilities, unless they are oriented towards fulfilling sustainable communities goals, because the collective benefit to local governments from these activities likely would be limited.

Adopt Independent Audit Requirements, Reject DOF Audit Authority. We recommend the Legislature adopt the Governor’s proposal to require financial and performance audits of IFDs that issue bonds every two years. At the same time, we recommend the Legislature reject the Governor’s proposal to allow DOF to audit IFDs. Instead, we recommend the Legislature adopt financial review standards for IFDs similar to those required for other local governments. Specifically, we suggest requiring IFDs to submit a report of annual financial transactions to the SCO. The SCO, in turn, would compile the IFD financial reports in an annual publication or include it within the financial report of special district financial transactions.

Adopt Interagency Loan Provision. We recommend the Legislature adopt the Governor’s proposed change that would allow affected local governments to loan funds to IFDs. This could help

to mitigate some barriers to forming an IFD, such as funding IFD startup costs.

Reject Governor’s Changes to Voter-Approval Requirements, Consider Alternatives. We recommend the Legislature reject the Governor’s proposal to maintain existing voter-approval requirements for IFDs but lower the voter-approval threshold to 55 percent. Instead, we suggest the Legislature consider two alternatives.

- ***Restructure IFDs to Resemble Similar Local Entities.*** Under this alternative, the Legislature would (1) require IFDs to have their own governing body separate from the governing bodies of their sponsoring local governments, (2) clarify that IFDs are separate legal entities from their sponsoring local governments, and (3) align local government requirements regarding IFDs to their requirements for substantially similar actions—such as forming JPAs and issuing JPA debt—by removing statutory voter-approval requirements for IFDs. This alternative would make it significantly easier for local governments to use IFDs. In addition, this approach mitigates potential conflicts with the Constitution’s voter-approval requirement for city and county debt by clarifying that IFDs are a distinct legal entity.

- ***Expand Voter-Approval Requirements.***
Under this alternative, the Legislature would expand IFD voter-approval requirements to allow all residents of affected local governments to vote. This alternative recognizes that the issuing of IFD debt establishes a long-term commitment of resources that otherwise would be available to the entire community (not just the residents of the IFD). We note, however, this alternative would make it more difficult for local governments to use IFDs. In response, the Legislature may wish to lower the voter-approval threshold

to form an IFD, issue IFD debt, or both. If the Legislature lowered the voter-approval threshold for IFD debt, we suggest taking actions (1) and (2) from the first alternative to mitigate constitutionality concerns.

Reject New Stipulations on Creation of IFDs.

We recommend the Legislature reject the Governor's proposal to require cities and counties to meet certain conditions related to RDA dissolution prior to creation of an IFD. In our view, it is inappropriate to deny use of an economic development tool to a local government simply because it is disputing state actions related to RDA dissolution.

LAO Publications

This brief was prepared by Brian Uhler and reviewed by Marianne O'Malley. The Legislative Analyst's Office (LAO) is a nonpartisan office that provides fiscal and policy information and advice to the Legislature.

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