Funding Public Infrastructure Improvements for New Development

Overall Effect on California Petroleum Use		Affects Petroleum Demand Through Intermediate Indicators:	
Magnitude	Medium-High	**Primary**	Distance Traveled
Certainty	Low-Medium	**Secondary**	
Applicable Level of Government	Local, State		
Relevant Laws or Cases Affecting Factor	California Constitution Article 13A California Health and Safety Code §34161 California Government Code §53311-53368.3		
Time horizon for implementation and maturity	Changing state policy to better accommodate infill project financing needs would have an immediate effect on new development projects. However, as with any land use change, the legacy effects of past decisions will remain for decades.		
Relevant Topics	Municipal finance, impact fees, infrastructure finance		
Summary	In post-Proposition 13 California, developers pay for much of the additional infrastructure required to support new development: schools, sewage systems, water delivery, and transportation improvements. While California law provides several options to finance public infrastructure improvements, some financing mechanisms are more applicable to greenfield development than to urban infill and brownfield development. If there are fewer barriers to financing infrastructure in greenfield areas than infill areas, the net result would be a distortion of land use patterns that favors additional distance traveled.		

Introduction

Proposition 13 (California Constitution Article 13A) amended California's constitution and significantly changed California's financing system for a variety of public services, including the infrastructure required for new development. Before 1978, local governments often financed the infrastructure improvements needed for new development with the current year's property tax receipts. Proposition 13 limited *ad valorem* property tax assessments to 1% of a property's assessed value. The constitutional amendment rolled back each property's assessed value to 1975 levels and limited increases to a 2% annually. While the state initially backfilled local government coffers with other sources of revenues, today the

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constitutional amendment significantly strains local government's ability to finance public services.

Proposition 13's passage likely stimulated growth in suburban communities and reduced options to finance infrastructure needed for infill developments. In the years since Proposition 13, cities and counties have become increasingly reliant on impact fees and alternative property assessments to finance public infrastructure improvements.

Brueckner (1997) evaluated a city's transition from current sharing to impact fees. Current sharing describes a financing structure where the cost of infrastructure expansion is shared equally among all of the city's landowners, as was typical in California prior to Proposition 13. Impact fees, common in California after Proposition 13, charge new development for most or all infrastructure expansion costs.

Brueckner found that the transition's effect on real estate markets depends on the growth rate of a community's property tax rolls. If, under a current sharing system, annual property tax increases exceeded interest rates, a switch to impact fees would stimulate growth. Where property tax payments grew at a lower rate than mortgage interest, growth would temporarily cease. The late 1970s and early 1980s were a time of great suburban expansion in California. Thus, Proposition 13 may have provided fast-growing suburban areas with an additional stimulus.

Proposition 13 had a greater effect on property prices in cities with higher property tax rates. A 1982 study of the Northern California real estate market found that every one dollar in property tax reduction lead to a seven dollar increase in a home's purchase price (Rosen, 1982). This finding indicates that the effect property tax reduction was capitalized into the purchase price of homes—meaning Proposition 13 provided a one-time boost captured by those who owned property at the time it took effect. The author notes that this study, conducted while the state was still able to backfill local revenues, did not capture housing price changes that would result from deteriorating public services. The backfill has waned in the 30 years since, leading variations in community service levels that may now be captured in housing prices.

New Financing Mechanisms

A new system of public infrastructure finance emerged in California after Proposition 13.

Impact fees

Impact fees internalize much of new infrastructure's cost through an upfront payment, paid by developers of new buildings. Though levied on the developer, the fees are most often absorbed by subsequent landowners, homebuyers and renters (Delaney & Smith, 1989). After Proposition 13 passed, many California cities transitioned towards using impact fees to finance new development.

Mello-Roos

The Mello-Roos Community Facilities Act of 1982 (California Gov't. Code Ch. 2.5, §53311-53368.3) was a direct response to the revenue limitations imposed by Proposition 13.

Communities or property owners that establish a Mello-Roos District can use special tax revenues to fund services or finance debt incurred for facilities that benefit the district (Raineri, 1987). Establishing a Mello-Roos district requires two-thirds approval of registered voters living within the district, with equal weighting of each vote. If fewer than

twelve persons are registered to vote within the proposed district, then landowners can vote. Landowner's votes are weighted proportional to the acreage each holds. Some Mello-Roos districts use this to their advantage—a group of fewer than twelve developers can issue debt to create new schools, parks, and other facilities that is then paid off by future landowners (Bort, 2006).

Mello-Roos financing doesn't give these developers a free lunch—but rather enables easy access to low-cost borrowing. Mello-Roos district assessments, like most property assessments, are reflected in real estate values. A 1994 study of Mello-Roos districts found that differences in tax payments are capitalized into purchase prices at an implied 4% discount rate (Do & Sirmans, 1994). This means that though the improvements funded by a Mello-Roos district are financed over time, the assessment is reflected in lower purchase prices for new homes and re-sales.

Assessment District

Assessment Districts are a long-standing option to fund public benefits using special assessments added to property tax bills. The legal requirements to establish an assessment district depend on the "special benefit" to be funded. The California Legislature has enabled nearly 20 different types of Assessment Districts covering a variety of facilities and services ranging from business improvement districts to pedestrian malls to fire protection. In general, the amount of the property tax assessment must be based on the benefit derived from the improvement—rather than the value of a property.

After Proposition 13, stakeholders quickly questioned whether Assessment Districts skirted the new limits to *ad valorem* property taxes. State Courts ruled that Assessment Districts are not subject to the one percent *ad valorem* property tax limitation and are not subject to a two-thirds approval mandate[1]. However, Proposition 218 (1996, California Constitution Article 13C - D) narrowed the definition of "special benefit" to prohibit new special assessments from funding any existing services or infrastructure.

Special Districts

Special Districts are limited purpose local governments that provide services or maintain facilities for several communities. Because they serve a larger geographic area, the formation of new special districts is more applicable to greenfield areas than infill areas. The Metropolitan Water District, the Sacramento Municipal Utility District, and the Los Angeles County Transportation Authority are the state's largest special districts, by expenditures.

Special districts can fund ongoing expenses or finance capital projects with property taxes, which require a two-thirds voter approval. Proposition 13's reduction in property tax revenues caused declines in special district revenues. Between 1978 and 1992, the state backfilled the declines using a Special District Augmentation Fund. These revenues were diverted to the Educational Revenue Augmentation Fund, part of a growing trend to redirect property and income tax revenues to K-12 education in the wake of 1988's Proposition 98[2], which set constitutional mandates for state education funding.

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[1] See (*Fresno County v. Malmstrom* (1979) 94 Cal.App.3d 974; *Solvang Municipal Improvement District v. Board of Supervisors* (1980) 112 Cal.App.3d 545; *County of Placer v. Corin* (1980) 113 Cal.App.3d 443)

[2] Proposition 98 Amended various sections in Articles XVI and XIIIB of the California Constitution, and §§41300.1, 14020.1, 14022, 41302.5 of the Education Code

Redevelopment - tax increment mechanisms

Until 2011, California cities were able to establish Redevelopment Agencies and designate redevelopment areas. After a city dedicated an area for redevelopment, future increases in property tax revenues would be diverted to the redevelopment agency. The redevelopment agency would borrow against this funding stream to finance public benefits for the area—usually infrastructure and services, but also developer incentives to catalyze redevelopment. The practice, known as tax increment financing, was quite popular in California because it did not require approval from voters or the special districts whose tax revenues were diverted. Redevelopment, along with tax increment financing, was dissolved in California on October 1, 2011 by AB1X 26 (Health and Safety Code §34161).

Geographic Applicability of Financing Mechanisms

Impact fees and tax increment financing do not require the approval of existing property owners, making these mechanisms easier to implement in infill areas. Mello-Roos and Assessment Districts are most easily formed in greenfield areas with few property owners, and most have been formed in such areas (Orrick & Datch, 2008).

Infill development projects often face a challenging infrastructure scenario that greenfield developments do not. This scenario limits a community's reliance on impact fees to fund infill infrastructure improvements.

The California Environmental Quality Act requires local governments to analyze new development's effects on existing infrastructure before approving a new project or plan. When a local government studies infrastructure needs on a project-by-project basis, as is common in California, planners evaluate a project's incremental impact on existing infrastructure. Planners examine the existing infrastructure's ability to accommodate the new project using thresholds of significance, or infrastructure performance standards. If the incremental effects of new development will cause infrastructure to fail to meet performance standards, then the developer must often pay the full cost of required infrastructure improvements. For example, an incremental increase in sewage load due to a new development may necessitate replacing an existing 12-inch sewage pipe with a 16-inch sewage pipe.

When infrastructure impacts are analyzed incrementally on a development-by-development basis, a single development project triggers the threshold. The last project to be approved pays the fee, even if other recently approved or constructed projects added more sewage load. If the required infrastructure improvements are costly relative to the developer's anticipated profit, then the impact fee may lead to project delays or termination.

If local governments analyzed the infrastructure impacts of all development expected in the next 15 years, planners might conclude that a 24-inch pipe is required. For example, a local government might expect a significant increase in density around a transit station. However, this new development may occur over several years, requiring uncertain future impact fees to finance current infrastructure improvements. Local governments often used tax increment financing to overcome this infrastructure financing gap.

Local governments cannot use Mello-Roos Community Facility Districts for transit station areas because the deficient infrastructure or service is preexisting – an expansion does not bring a novel special benefit. Assessment Districts may be applicable to such areas, but obtaining approval from existing property owners is more difficult in infill areas than in greenfield areas. Few existing property owners may want to subsidize improvements that

will primarily benefit new developments.

Financing needed infrastructure improvements is more complicated in infill areas than in greenfield areas. However, fewer financing mechanisms are practical in infill areas. The net result is likely an increase in greenfield development versus infill development versus what would occur under a level playing field. The consequence is additional development in suburban and exurban greenfields and additional vehicle miles traveled.

Estimated Effects on Motor Vehicle Fuel Use

Existing academic literature has not estimated the change in travel activity attributable to the post-Proposition 13 funding environment. This is not because of any disinterest in the subject, but rather because academics lack data to perform a high-certainty estimate. A best-guess estimate is possible using statewide travel activity between 1980 and 2010. During this time, Vehicle Miles Traveled (VMT) per licensed driver rose 3,982 miles, from 7,265 miles to 11,147 miles. Controlling the number of registered vehicles available per licensed driver, even if only 10% to 25% of the increase were attributable to changes in infrastructure finance, then the result would be a significant increase in statewide VMT. At 10%, 2.2% of current VMT and motor fuel use could be attributed. At 25%, 5.5% could be attributed.

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