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SPECIAL ASSESSMENTS AND ALTERNATIVE FUNDING METHODS FOR PUBLIC IMPROVEMENTS IN OTHER STATES

North Dakota law allows establishment of improvement districts for public improvements, issuance of bonds to finance the improvements, and levy of special assessments against property to retire the bonded indebtedness. North Dakota cities have had this authority by statute since 1897. It appears this method of financing public improvements is the oldest and most common method among other states. Special taxing districts in other states may be called special improvement districts, general improvement districts, public improvement districts, municipal utility districts, community development districts, or community facilities districts. These districts and financing mechanisms are used by other states in a manner similar to uses in North Dakota to finance roads, streetlighting, traffic control, water and sewer service, public buildings, recreational facilities and parks, and other public improvements.

Financing by special taxing districts provides several advantages over funding of improvements by property developers or property owners. For cities or other political subdivisions, the advantages of improvements through special taxing districts include direct control of specifications and execution of the project, accelerated completion of improvements, transfer of funding of projects to the private sector to preserve debt capacity and property tax authority of the jurisdiction, better quality and improved uniformity of public improvements, and allowing new growth to pay its own cost of infrastructure development. For developers, special taxing districts avoid tying up developers' equity in infrastructure development, avoid tying up developers' time in infrastructure development, avoid possible recourse against the developer during the 20 years or 30 years the indebtedness is outstanding, reduce borrowing costs because bonds are tax-exempt, and allow for higher returns to the developer or lower sales prices for property, or both. For property buyers, special taxing districts provide the advantages of construction of improvements under control of the city, faster completion of public improvements, higher quality and improved uniformity of public improvements, and reduced combined costs of property ownership.

Several alternatives to traditional funding through special taxing districts have been developed in other states.

ALTERNATIVES TO SPECIAL TAXING DISTRICT FUNDING

Tax Increment Financing

Tax increment financing freezes the existing tax revenue generated by property to be improved. As the property is developed and generates higher property taxes, the increased tax goes to a special fund to pay indebtedness incurred for the improvements. Once the indebtedness is retired, property taxes are unfrozen and the full tax is allocated among taxing districts. The key to the approach is that no new taxes are required, no existing taxes are used for financing, and the debt limit of the political subdivision is not affected.

Impact or Development Fees

In some states, cities are allowed to impose impact or development fees against property developers to cover the cost of infrastructure improvements. The presumption is that the developer will pass the impact or development fee cost along to property buyers. This approach is generally viewed as undesirable because the property buyer ends financing the cost of infrastructure improvements, usually at a higher rate of interest than is available through public financing. In addition, impact fees are viewed as restrictive on development because they increase the developer's risk. This is viewed as particularly detrimental during slow housing markets and economic recessions.

Bond Banks

State-sponsored bond banks do not directly fund infrastructure projects. However, many states have established a state bond bank to allow local government borrowers to obtain a lower rate of interest on indebtedness than is directly available to them. By consolidating indebtedness of smaller municipalities, improved credit ratings are available. Advantages include reduced interest rates and costs of issuance and improved access to municipal bond markets.

Revenue Bonds

Revenue bonds are limited liability obligations secured by revenue from the project being funded. Revenue bonds are not backed by the taxing power of the issuer and do not count against debt limitations. Because repayment is limited to the revenue stream from the project, revenue bonds generally bear a higher interest rate than general obligation bonds, which are backed by the property in the jurisdiction.

Lease Financing

Initially used for acquisition of equipment by governmental entities, lease financing has become an increasingly common way of funding acquisition or construction of public buildings. Use of building authorities in North Dakota is an example of the lease financing approach. An entity is established to construct a building and issue bonds. The bonds are eligible for tax-exempt status under federal law and a 1963 Internal Revenue Service revenue ruling. The

agreements are structured as a series of one-year renewable lease contracts, subject to the ability and willingness of the political subdivision to appropriate funds for lease payments.

Under a leasing arrangement, a political subdivision can finance projects without incurring indebtedness for purposes of state laws requiring voter approval and imposing debt limitations. However, interest costs associated with lease financing are generally higher in comparison to other indebtedness vehicles available to political subdivisions.

Certificates of participation are the most commonly used form of municipal lease financing arrangements. Under certificate of participation financing, investors acquire a fractional interest in rental payments, in denominations of $5,000 or $10,000, which are payable yearly from the rental payments. Certificates of participation also carry a higher rate of interest because they are considered a riskier investment due to the fact that the political subdivision can terminate the lease.

Special Districts

A special district may be established in some states to provide a specific public service, such as water, fire protection, police protection, or flood control. Special districts are not a part of the city or county and are a legally separate entity. The perceived advantage of special districts is that they allow charges to be imposed directly against those who benefit from the service provided, which supposedly allows a better quality or range of services at a price consumers are willing to pay. Special districts may be viewed as an inequitable financing method. Poorer neighborhoods are not likely to benefit from special districts because residents cannot afford to pay for enhanced public services.

Community Development Authorities

Community development authorities are quasi-governmental entities created under laws in some states. These entities are given the right to issue tax-exempt debt to fund infrastructure. It appears the objective of these entities is to allow a developer to establish the authority and issue tax-exempt debt. A tax surcharge is added to homes within the established district. The concept is intended to provide lower costs through tax-exempt borrowing and eliminate the need to add infrastructure costs or impact fees to the price of a home. Available information indicates that these authorities are costly to establish and limited to very large-scale developers.

Design-Build Projects

In traditional development, the design and construction portions of projects are entirely separate. Under the design-build approach, design and construction are performed by the same entity. An additional variation is a design-build-operate project. The intended benefit of the design-build approach is to minimize costs by giving bidders an incentive to be efficient in design and construction and use advanced technology. The savings are intended to be passed on to the community through lower costs, better services, and less financial impact for property buyers.

State Revolving Funds

State revolving fund programs provide loans to political subdivisions at reduced cost, and loan repayments go back into the fund to allow funding for additional projects. Funds for some purposes, notably water projects, are provided from federal government grants and state matching funds. Federal funding to these programs has declined since 2002.

Grant Anticipation Revenue Vehicle Bonds

Grant anticipation revenue vehicle (GARVEE) bonds allow states to pledge a portion of future federal highway funding toward repayment of indebtedness. A qualifying project must be preapproved by the Federal Highway Administration as a federal aid debt financed project. The benefit of GARVEE bond funding is to allow faster implementation of certain highway construction projects. However, obligating future federal funding necessarily restricts choices on future use of those revenues. A further risk is whether federal revenue allocations will be reauthorized or continued.

Privatization

Privatization describes performance of traditional public services, such as education, libraries, water treatment and supply, roads and bridges, public transportation, law enforcement, fire protection, and similar services through competitive contracting with private operators. These agreements generally require that the infrastructure already be in existence and in ownership of the political subdivision. Contracts are of a limited duration to retain cost control through the competitive bidding process.

A related innovation is asset sale of public infrastructure to a private entity. Sale of an asset, such as a water distribution system, can relieve the political subdivision of the burden of maintaining the system and produce an infusion of cash. However, there is often political resistance to transferring a traditionally public function to the private sector.

Public/Private Partnerships

A public/private partnership describes contractual arrangements in which a private sector entity is required to design, finance, build, and perhaps operate public infrastructure or facilities. The attraction of such arrangements may include reduced cost of services to the public, reduced payroll and other costs for the political subdivision, and avoidance of debt limit and voter approval issues. Some observers estimate that private sector construction costs may be 10 percent to 30 percent lower than

public sector construction costs and that private sector projects can be built in a much shorter timeframe.

Financing Equitable Impact Fees

It appears impact fees have become more common across the country. Impact fees are said to be overstated by most jurisdictions. Financing impact fees means the political subdivision finances the pro rata share of infrastructure costs for new housing units and imposes an annual surtax on the new owner to retire the indebtedness. Instead of imposing an impact fee on the builder, who in turn passes the cost to the new buyer in the form of higher housing prices, the new property carries a liability through an annual tax surcharge. Unless impact fees financed on behalf of the property owner are significantly less than the costs to the homeowner of retiring special assessment debt, it appears there is little advantage in this approach. However, if development costs are converted to a property tax for the homeowner, they may become deductible for federal income tax purposes and allow the homeowner to shift some of the cost to the federal government. Special assessment installments are not deductible for federal income tax purposes, so there may be a cost advantage for the homeowner if development costs are converted to a property tax.