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Economically Efficient Funding of Special Districts in Utah

by

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Summary and Conclusions.

From the analysis and review of the literature presented in this paper, we can conclude at least the following points:

1. All citizens benefit from growth in a region, thus it is reasonable to expect that existing citizens as well as newcomers should share in the costs of growth.
2. Forcing special districts to substantially fund their capital expansion needs through impact fees is economically inefficient, and is tantamount to double taxation on newcomers to the region.
3. Special districts should be allowed to have access to general property tax revenues for capital expansion, because property taxes appropriately target many of the gains paid to all citizens when growth occurs.
4. Income taxes which are currently collected on land development and speculation profits should be returned to the community from which they were paid to assist in the development of necessary public capital infrastructure.
5. Property tax revenues are the lowest-risk source of revenue to pay for public capital infrastructure expansion, thus allowing access to the lowest interest rates possible when issuing public debt.
6. Depriving special districts access to property tax revenues will increase debt service costs as well as potential defaults on public debt.
7. Disallowing citizens the opportunity to pay for special district services through property taxes will increase the cost of those services due to a loss of income tax deductibility.
8. Forcing special districts and their limited pool of existing fee payers to assume all the risks associated with expanding public capital on behalf of the entire community, to stay ahead of population growth, violates every measure of economic equity.

Special districts which provide critical services such as water and sewer play a vital role in facilitating growth in Utah. These districts engage in long-term planning and pursue capital expansion that makes growth possible in an orderly manner. Even if some of these districts currently provide a benefit that is narrowly focused on a few activities at present, the natural and capital resources that they have developed will be of extreme importance in making orderly growth possible for the future. These existing resources, and the new ones that are being planned, will ultimately benefit all citizens in their respective regions, newcomer and current residents alike. Special districts are necessary public entrepreneurs. These districts must be allowed to operate in their current long-term planning mode of operations. The present mix of funding mechanisms plays an important role in spreading the risks associated with capital expansion appropriately to those who will receive the benefits of growth. Denying these districts access to general property tax revenues could be disastrous to the State of Utah in the long run.

Introduction.

An important issue that all societies face is how to best provide for public infrastructure. Important questions always arise regarding how, whom, when, and how much. Water, sewer, and other similar public capital needs must grow in such a manner as to keep pace with population growth. No one wants water rationing, or having sewage going places it should not. The problem is that populations grow at fairly smooth rates, one household at a time, but new public capital needs must be added in large projects that cost millions of dollars. The high cost of adding the necessary public capital begs the question of who should pay for these needs, how and when. This paper evaluates these questions, and several alternative methods for financing the expansion of public capital through special districts. Specifically, this paper addresses the following questions:

1. Should current citizens be expected to bear part of the cost of developing new public capital made necessary by growth? If yes, how should the money be collected?
2. What is the appropriate use of impact fees for financing public capital expansion?
3. How would disallowing special districts access to property taxes harm citizens of the State of Utah?

Existing Citizens versus New Citizens.

One of the most important questions for any growing region is who should pay the costs of the new public capital infrastructure needed to support higher populations. The struggle between the interests of existing residents versus new residents over who pays the bill can be seen in virtually every growing community in Utah. The field of economics has much to say on the issue from the literature in land economics, as well as from broader literature on the subject of intergenerational equity (For an example of excellent current work, see the November, 1997 issue of Land Economics). Intergenerational equity simply means, fairness regarding how older generations of citizens make decisions that impact younger generations, or generations yet unborn. By extension, intergenerational equity can also imply fairness between existing residents versus newcomers into a region.

When evaluating the question of whom should pay the cost of new public capital, a basic rule called Pareto Optimality should be applied. This rule is that when making allocation decisions, no person should be made better off at the expense of another. Or, conversely, we should make decisions that improve the quality of life for some, as long as the quality of life for others is not reduced. This, of course, is idealistic. The realistic application of this rule is that where the actions of some negatively impact others, there must be adequate forms of compensation for that negative impact, thus leaving the harmed party in a neutral position.

One way to think about communities is to use the analogy of stockholders in a firm. In this analogy, all citizens in a community are stockholders. The board of directors, appointed by the shareholders, are state and local governments. All citizens in the region are shareholders, whether they be new move-ins or long-term residents. Each has a right to vote, whether they just purchased a share of stock, or whether they have owned a share for 40 years. Within the firm, stockholders are the primary bearers of risk. The risks borne in reality by citizens include the risks of expansion of new capital facilities and infrastructure to facilitate growth. In return, citizen shareholders receive a rate of return on growth. The positive rate of return on growth for existing residents includes the following:

1. Direct cash profits on land development and speculation
2. Capital gains on all existing previously-developed property
3. Better health care
4. Better shopping, with greater selection
5. Greater range of entertainment options
6. Higher probability that future generations can get jobs in the area
7. Higher real incomes per household

Factors that create a negative rate of return associated with growth include at least the following:

1. Congestion
2. Pollution
3. Crime

If markets operate with even modest efficiency, the net rate of return (Positive minus Negative returns) for growth should be positive. The primary variables that cause the rate of return on growth to be positive for existing residents include rising land prices, rising incomes, and increasing the level of economic opportunities of younger generations. Rising land prices increase the value of all property. Rising land prices increases the capital gain to existing property owners, as well increasing the direct cash profits for land speculators and developers. Thus, even if social costs associated with growth are rising, rising land prices create a positive payment to existing residents to offset those costs. Nearly all existing households benefit from rising general income levels through regional multiplier effects. The distribution of newly-created income is of course dependent on the entrepreneurial abilities of residents, as well as educational attainment. It can also be easily argued that existing households benefit from growth, which always brings with it growth in opportunities, both in terms of income for household members currently in the labor force, as well as children who will now have a greater range of opportunities to stay in the area and earn income sufficient to take care of their own independent household.

The fact that existing households benefit from growth is of paramount importance. There is an axiom in public finance, which is, that those who receive the benefits should also bear the costs. By extension, we can conclude that those who receive the greatest benefits should bear the most costs. It is true that new residents also benefit from moving into a new area. Were it not true, one could question the reasons why residents are moving into the region. Newcomers should also bear some costs, which they often do in the form of paying higher land prices, hook-up fees, etc. However, it is not unreasonable to ask that existing residents also make payments toward the rate of return that they are receiving from growth.

The general property tax is an appropriate form of taxation on existing residents to pay for the rate of return they are receiving on growth. Further, recent work by Nechyba (1997) has shown that utilizing property taxes is far preferable to local income taxes when engaging in community planning issues. This research shows that the major source of financial volatility for communities is migration of households, and that financial volatility is generally lower for communities which rely on property taxes. Property taxes are also reasonable on general equity grounds, in the sense that property taxes appropriately target some of the larger benefits paid to existing residents. As mentioned earlier, growth benefits are provided through higher land prices in two ways: 1) Through providing capital gains to existing households who own property; and 2) Through providing to land developers and speculators pretax profits that are often well in excess of the normal rates of return available from similarly risky investments available in the market. This is particularly true during periods of rapid growth.

The supply of land is fixed within a region. As demand rises due to growth, prices rise automatically. The more that developed or developable land is constrained relative to demand, the faster prices rise for both developed and undeveloped land in the region. As prices rise, growth becomes more and more exclusive in a region, and growth rates slow. Developers attempt to counteract the effects of rising land prices by building on smaller lots, but ultimately, higher land prices make a particular area less attractive to buyers than other alternative areas. In spite of slowing growth, however, the capital gain paid to existing residents persists over time.

Earning a capital gain on rising land prices requires little work effort on the part of the owners. It simply happens, and the benefit is given to all existing residents who own property. It is one of the automatic premiums that existing residents are provided to endure bouts of growth. It is partial payment for the shareholder rate of return. When land is sold in a region, the land speculator makes a profit. When land prices get too high, growth will slow, and newcomers will eventually go somewhere else where land prices are less.

If demand is high, and the developer speculated on the land when it was less expensive, profits exist. The reverse can also be true, but not likely in a robust growing economy. As mentioned earlier, the profits on developed land are a major part of the social rate of return associated with growth. The problem is that the cash payments of profits and

capital gains are often distributed unevenly in the community, and sometimes these flow to out-of-region developers and landowners. Where property taxes are collected, the capital gain on real property is already taxed, assuming that local governments properly adjust taxable values of the property. This reduces the amount of the capital gain for current residents, but the net gain is still very much positive and useful to the owners.

In summary, it is perfectly rational to expect that current residents should bear some of the risks of new growth, and bear at least a portion of the costs associated with growth. Further, using the property tax as a mechanism to collect that payment appropriately targets the benefits provided by growth, at the same time reducing some of the financial volatility faced by local governments attempting to plan for growth and change.

<u>Proper Use of Impact Fees.</u>

Some might say that special districts do not need property tax revenue because they can charge impact fees to fund new growth. This is absolutely the wrong approach. As mentioned earlier, land developers and speculators make profits on their activities, which is to be expected and encouraged within a market system. These profits are taxed as income in the United States, and thus flow to the federal and state governments. It could be effectively argued, however, that the vast majority of tax collected on the cash profits associated with land development and speculation in a region should be given directly back into the community to help pay for broad capital expansion needs of the region. In reality, this does not happen well because of the funding competition that exists between the levels of government. This concept of flowing the income tax dollars collected on land development and speculation profits back to the local communities is consistent with the land economics literature which has consistently shown that the widely used alternative, general impact fees, are inequitable because the capital development costs that new growth causes are already capitalized into the final selling price of the land (Levine, 1994; Peiser, 1988; Moreau and Snyder, 1987; Snyder and Stegman, 1987; King, 1977; Hamilton, 1976; Pines and Weiss, 1976; Edel and Sclar, 1974; Lind, 1973; Oates, 1973 and 1969).

The profits on development and land speculation are already taxed as income, and after-tax profits still exist. Some may argue that charging impact fees will not effect new residents as much as it will further reduce the profits to developers and speculators. Such is not the case. In an interesting article regarding who bears the burden of impact fees, authors Huffman, Nelson, Smith, and Stegman show that under the most likely development scenarios, the majority of the impact fee will always be paid by the buyer, not the developer (1988). The determination regarding who bears the tax involves complex issues of supply versus demand elasticity, or sensitivity, to changes in the ultimate prices charged.

During times of growth, it is generally true that demand is much less sensitive to price than supply is, thus, buyers will generally bear the largest portion of the impact fee. This outcome is related to the commonly-known reality that growth brings with it a sellers-market.

Thus, charging newcomers higher prices for land which provides capital gains for all current residents, as well as generating large profits for developers and speculators, and then charging an impact fee on top of it is tantamount to double taxation. The appropriate public policy response should not be one of figuring out how to get into the pockets of newcomers as much as it should be focused on having the income tax payments on development profits returned to the community. Here is a simple example showing how newcomers to a region already pay for the impact of growth, and that no general impact fees are needed. This example also demonstrates why local governments must be allowed to retain the income tax collected on land development and speculation profits.

Let us assume for a moment that a community has 10,000 households. If the average land value per household was $30,000 before growth occurred, but raised 10 percent to $33,000 after two years of 4 percent population growth, then the total capital gain experienced by households was $30 million. If property taxes were collected at 1 percent of market value, then tax revenue would rise by $300,000 from exiting property owners. The number of households would have increased by 816, assuming 4 percent annual growth over two years.

The value of land per new household would be at the new average, or $33,000. This was land that was converted from an undeveloped to developed state. Let us assume that the undeveloped land value was $10,000, and the cost of improvements, marketing and closing was $13,000. This leaves taxable income of $10,000. If the developer has a combined state and federal income tax rate of 40 percent, then this implies that income tax contributions due to the sale of the land to new citizens is $4,000 per new household, or $3.264 million. Added to this is the property tax that new citizens will pay on their $33,000 land value. If tax rates are 1 percent of market value, then new property tax collections from new residents will be $330 per year each, or $269,280.

Further, the new property tax collections from new residents and a portion of the property tax on the capital gains to existing residents could partially be used to issue new public debt to pay for infrastructure expansion. If all residents were assessed a $15 per year payment toward debt service for capital improvements and expansions, that would be half of the property tax on the capital gain received by existing residents, and would be $15 of the $330 property tax paid by newcomers. This being the case, total monies collected to make annual amortization payments on debt would be around $162,240. This annual payment translates into borrowing approximately $2.500,000 for capital improvements at 5 percent over 30 years. The total immediate funds available, minus amortization payments, becomes $6,170,651, or $7,562 per new household.

The analysis provided above has not included the contributions by new households to sales taxes or income taxes, or to property taxes on the home and other non-land assets; all of which can be used to pay for immediate increases in operating expenses of governments. This analysis also does not consider the positive economic multiplier effects of the land development and construction processes on regional income payments to households. Thus, as growth occurs, it can, and most often does pay its own way without impact fees. The difficulty that local governments face is the way we tax and allocate tax revenues between levels of government, particularly with respect to the profits on land speculation and development. This, however, is not the fault of newcomers to a region. Disallowing local communities to have access to the income tax on land development and speculation profits that are already being collected causes substantial hardship on local communities and narrows the distribution of benefits from growth. Further, it pushes the local governments into a position of having to use general impact fees, even though they are a form of double taxation.

Some communities have recognized this problem, and have moderated their approach to charging impact fees, reduced them, or in some cases eliminated them. Hemet, California recently adopted an ordinance allowing the amortization of impact fees over a seven year period, while reducing the overall level of those fees. This action reduces the impact of the fees on proposed development, making more projects economically viable (Temple and Cooper, 1996).

In summary, general impact fees are not an economically viable means of paying for development. Collecting impact fees may be a practical necessity to an extent until other more efficient funding mechanisms can be developed. However, these fees should be minimized. At no time should a local community become predatory on newcomers simply because existing residents have the political power to do so. Excessive use of impact fees, and other forms of "takings" have been under legal scrutiny of late as well as having been of serious concern since the drafting of the Constitution.

The Fifth Amendment of the Constitution states that persons shall "...not be deprived of...property, without due process of law; nor shall private property be taken for public use without just compensation." The concept of a property "take" has been a thorny one over the last 207 years since the Fifth Amendment was ratified. James Madison declared that property could not be directly taken without compensation, and further stated that a government which indirectly violates their property, in their actual possessions...is not a pattern for the United States (Ely, 1992). Does requiring owners of land to share the value of that land with government as a condition of development constitute a taking? Clearly the answer to that question is yes.

In 1922, the Supreme Court of the United States ruled in Pennsylvania Coal Co v. Mahon that any government regulation that goes "too far" in imposing costs on property ownership constitutes a taking. In that decision, Justice Holmes set an enduring standard, albeit extremely vague.

Up until the mid 1980's the courts upheld governments right to seize some properties under the rights of policing power. The power of government to exercise police power to uphold health and general welfare are used as justifications to engage in taking without compensation, as police power regulation is not a taking of property for which compensation must be paid (Epstein, 1995). These cases include the imposition of zoning laws, but in times past these policing powers extended to taking lands without compensation for dedication of lands for utilities, roadways, etc.

In 1987 the Supreme Court heard the case of Nollan v. California Coastal Commission. In this case the court held that any public entity seeking to force a property owner to dedicate property for the public good must show an "essential nexus" between the required dedication and the desired outcome. This ruling tightened the sometimes arbitrary use of the dedication powers of state and local governments, but the ruling failed to address the question of reasonableness; if the nexus is present, to what extent is the required dedication reasonable.

In a recent landmark case (Dolan v. City of Tigard, 1995) the Court ruled that while the Planning Commission demonstrated that the "essential nexus" did in fact exist, it failed to establish the reasonableness of its attempt to exact ten percent of Dolan's property for storm drain enhancement and the establishment of a bike/pedestrian trail. In this ruling the Court severely limited municipal and state governments ability to impose dedications and exactions under policing powers to thus avoid compensating land owners fair market value, as mandated under the takings clause of the Fifth Amendment. This ruling will "level the playing field" in planning and development processes wherein property owners have historically been disadvantaged versus governments. Further, this ruling brings impact fees under greater scrutiny, as property owners are required to pay fees, or a portion of the value of their property to government. Impact fees must also pass the "essential nexus" test; they must demonstrate a clear connection between the imposition of the fee and the reasonable and appropriate use of those fees. Impact fees and other forms of exactions and dedications must also pass a proportionality test as per the Dolan ruling. That is, the amount of money exacted from land owners must be roughly proportional to the net cost impacts that they impose. Economists would add, that the proportionality test for impact fees should be modified to become:

Impact Fee = costs imposed - (tax on capital gains paid + tax on development profits paid)

While impact fees may be a reality that local governments face in the short-run, these same levels of government should work to secure flow back of the income taxes paid on land development and speculation profits. In the mean time, consideration should be given regarding the current ways in which newcomers are already compensating communities for the problems associated with growth, even though that compensation is not through direct tax dollars.

Impact of Disallowing Special Districts Access to Property Taxes.

Some might argue that special districts, since they have the capacity to charge user fees, should be disallowed access to general tax revenue. On the surface, it is tempting to think that way, as it would appear that such a policy forces those who bear the benefits to pay the costs. However, as pointed out in the previous two sections, public infrastructure enhancements required due to growth should be borne by existing residents and newcomers alike. When it comes to the issue of funding special districts for water and sewer, or similar critical services, it is clear that such districts have played an important role in providing a broad public benefit. Such districts have borne risks to develop the public capital necessary to provide essential services on which both present and future generations rely.

It is clear that special districts which provide broad public benefits are entitled to broad public funding. Rescinding the right of such districts to have claim on broadly defined taxes in the region would be economically incorrect, as it would force a relatively narrowly defined set of district members to bear the entire cost of providing benefits for the entire body of citizens in the
region. In a more complex vein, disallowing special districts such as water districts access to general property tax revenues creates a severe intergenerational equity issue. This is particularly true because of the rather "lumpy" nature of public capital infrastructure.

In an ideal world, a society could add public capital in tiny increments, to instantaneously match the rate at which populations are growing in a region. We do not live in an ideal world, however. Capital projects to provide essential services are very costly, and usually quite lengthy to complete. Further, there are some public services that can lag behind growth curves, but other services that must lead growth. These latter services include water development and distribution, and sewer treatment. Growth simply cannot happen if we do not have water for new structures, nor the capacity to process the waste these structures and their residents will create. The need for water and sewer developments to lead the growth curve will result in short-term excess capacity which imposes additional financial risks that need to be borne. A graphical presentation of the fundamental problem is provided in Figure 1 below:

Critical Public Capital Growth vs. Population Growth

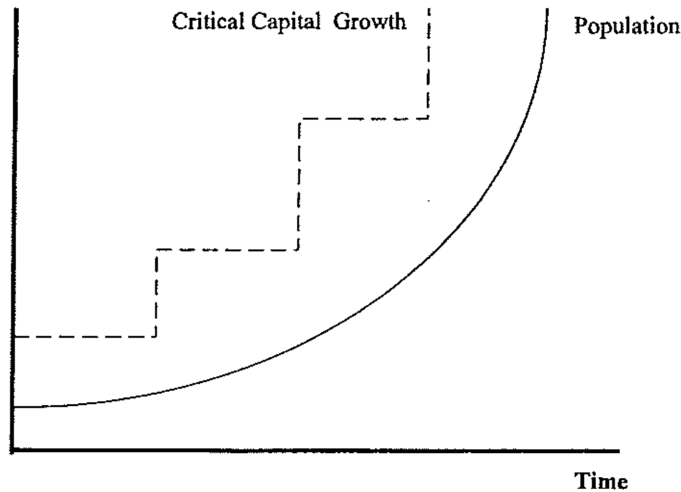

Figure 1

An important issue arises if growth is anticipated and planned for, but special districts are unable to access general property or similar tax revenues. First of all, those paying fees into the district will only include current users. However, what would occur if current users of services from the water district, for example, was less than 50 percent of the households in a particular region. This being the case, the special district, along with their limited pool of rate payers, would be forced to bear the entire risk of the development of new water resources on behalf of not only new residents, but also on behalf of the majority of the existing citizens in the region. Finally, if special districts are disallowed access to property taxes, district fee payers would be forced to bear even more risk because they would lose income tax deductibility of that portion of their own property tax payments that flow to the district. Asking district fee payers to bear nearly all of the financial risks associated with necessary public capital expansion is simply not reasonable, when all will benefit by that expansion.

To illustrate, consider a case where a municipality is currently supplying it's entire needs through pumping of underground water. Assume there is a water district in the region which has some developed water resources. The community is anticipating and planning for growth, yet there are few underground water rights available. Assume that there is a water district with a small reservoir, which could supply water needs for agricultural users, with some for the municipality as well. Users of the water district services do not include municipal users currently, but the water district is the logical entity to develop new reservoirs outside the municipality to facilitate growth within the region; and, in fact, there is a general expectation that the water district will do so. Without access to general tax revenues, the water district would have to independently speculate on the development of new water resources, pay for all of the excess capacity that would likely occur in the short run, without interim payment, and issue debt based only on the current base of fee revenue it collects. This becomes a financial nightmare for the district. If the district's fee base is small enough relative to the necessary size of the project, the district could well be forced to default on the debt issue if growth did not occur exactly as planned. This may constitute an unacceptable risk to a state that values its excellent bond ratings and fiscal management quality.

Special Districts are not private firms. If they were private, they could issue stock, as well as debt, and capitalize their future growth needs more easily. Disallowing special districts access to general property tax revenue would be tantamount to denying a private firm the opportunity to issue stock to achieve its capitalization needs.

As mentioned in the previous section, property taxes are the most stable form of revenue for local governments. When local government entities need to issue bonds to finance capital improvements, the source of revenue is considered by bond rating entities, as well as the buyers of those bonds. Municipal bonds that are backed only by user fees, or other revenue sources that are unstable, will tend to have a much higher cost of debt service and default than debt issues that have access to general property tax revenues. This becomes a very important issue when considering how to properly fund critical services provided by special districts. Higher debt service costs are but one of many problems that would be associated with conversion away from property tax revenues (Mackey, 1994).

Another form of risk that all taxpayers should fear is that some may desire to disallow special districts access to property tax revenues simply to reallocate those revenues to another activity of government. Such an effort would simply be a tax increase, and would create a policy that would transfer wealth from special district fee-payers to the general population, as well as increasing the tax and fee bill that all citizens pay for government services in the long run.

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From the analysis and review of the literature presented in this paper, we can conclude at least the following points:

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Special districts which provide critical services such as water and sewer play a vital role in facilitating growth in Utah. These districts engage in long-term planning and pursue capital expansion that makes growth possible in an orderly manner. Even if some of these districts currently provide a benefit that is narrowly focused on a few activities at present, the natural and capital resources that they have developed will be of extreme importance in making orderly growth possible for the future. These existing resources, and the new ones that are being planned, will ultimately benefit all citizens in their respective regions, newcomer and current residents alike. Special districts are necessary public entrepreneurs. These districts must be allowed to operate in their current long-term planning mode of operations. The present mix of funding mechanisms plays an important role in spreading the risks associated with capital expansion appropriately to those who will receive the benefits of growth. Denying these districts access to general property tax revenues could be disastrous to the State of Utah in the long run.

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