

A light gray silhouette of the state of California, oriented vertically. The text 'MELLO-ROOS FINANCING IN CALIFORNIA' is overlaid on the map.

MELLO-ROOS FINANCING IN CALIFORNIA

Kathleen Brown
California State Treasurer
And Chair

MELLO-ROOS FINANCING IN CALIFORNIA

September 1991

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STATE OF CALIFORNIA

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September 27, 1991

On behalf of the California Debt Advisory Commission (CDAC), I am pleased to release *Mello-Roos Financing in California*, a comprehensive review of the Mello-Roos Community Facilities Act of 1982.

Over the past eight and one-half years, more than \$3.2 billion in Mello-Roos special tax bonds have been issued by local governments in California. These bonds have financed the construction of needed public improvements such as schools, roads, freeway interchanges, sewage treatment plants, and a host of other public facilities. The growing reliance of California local governments on Mello-Roos bond financing reflects broader fiscal trends toward increased specialization and greater local responsibility. These trends came about as a result of the voter approval of Proposition 13 in 1978 and declining federal assistance for local infrastructure.

The Mello-Roos Act, however, comes with its share of added responsibilities for local government officials. The precarious nature of land-backed financing necessitates that public officials pay close attention to the credit structure of Mello-Roos bonds. In addition, local officials should be cognizant that excessive overlapping tax rates and inequitable tax burdens may result from the implementation of the Mello-Roos special tax.

To assist local officials in addressing their debt management responsibilities, the last chapter of this report includes specific planning and project evaluation guidelines for evaluating Mello-Roos proposals. I commend these guidelines to the attention of all local officials.

Sincerely,

A handwritten signature in cursive script that reads 'Kathleen Brown'.

KATHLEEN BROWN
California State Treasurer,
Chair, California Debt Advisory Commission

California Debt Advisory Commission

The California Debt Advisory Commission is the state's clearinghouse for public debt issuance information. The Commission was created by the California Legislature in 1981 to assist state and local government agencies with the monitoring, issuance, and management of public debt.

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EXECUTIVE SUMMARY

The Mello-Roos Community Facilities Act of 1982 (the Act) provides California local governments with an extremely flexible revenue source for financing needed public facilities and services. To date, the special tax authorized by the Act has been used primarily to secure bonds issued to finance the period of rapid population growth California experienced during the late 1980s, the volume of Mello-Roos special tax bond issuance increased dramatically. The Act has been used much less extensively in developed areas of the state due to the difficulty of obtaining two-thirds voter approval.

The growth in Mello-Roos special tax bond issuance has invited the scrutiny of investors, the media and public officials. There is a great deal of concern about the security of outstanding Mello-Roos special tax bonds. There are concerns about the public policy implications of authorizing public indebtedness through a vote of landowner/developers, which is how the vast majority of outstanding special tax bonds in the state were authorized. In short, there is an appetite for information about the status of Mello-Roos financing in California.

Accordingly, the California Debt Advisory Commission (CDAC) embarked on this review of the Mello-Roos Community Facilities Act of 1982, to shed some light on these and other issues, and to provide local governments with direction in approving the formation of Mello-Roos Community Facilities Districts, levying the special tax, and issuing bonds secured by the special tax.

This report begins with a discussion of the fiscal and political environment of the early 1980s which created the need for a more flexible financing tool to address the public facility demands of growth. The second chapter describes the procedural requirements for levying Mello-Roos special taxes and issuing bonds, and presents data on the use of Mello-Roos special tax bonds since 1983. The third chapter examines the public policy issues raised by the use of Mello-Roos financing. The fourth chapter focuses on credit quality issues surrounding the use of Mello-Roos special tax bonds. Finally, the last chapter of the report provides guidelines for local governments on the use of Mello-Roos financing. A brief summary of each chapter of the report follows.

CHAPTER I: FINANCING GROWTH: A HISTORICAL PERSPECTIVE

In order to appreciate the role that Mello-Roos Act plays in financing growth, it is important to understand the relationship between growth and capital financing in California and how that relationship has evolved over time. For many years during California's post-World War II population boom, the federal and state governments heavily subsidized the construction of public facilities, particularly those which produced statewide or regional benefits. At the local

level, the increased service demands caused by growth often overwhelmed existing governmental structures, leading to the establishment of new governmental entities. From a fiscal perspective, the demands for service translated into higher local property tax rates.

The constitutional restrictions on taxation imposed by Proposition 13, coupled with declining levels of federal assistance, required local governments to devise new strategies for financing capital projects. Cities and counties began to rely more on their legal authority to require developers to pay for infrastructure as a condition of development approval. Developer fees emerged as an important source of revenue for school facility needs, as well. Local governments also rediscovered the special assessment acts, which had been used sparingly since the Great Depression.

But these funding sources could only be used under restrictive conditions. Special assessments could finance improvements which confer a *special benefit* to identifiable properties; but they could not be used to finance facilities which confer communitywide benefits, such as schools and police stations. Developer fees were constrained by the inherent limitations of a "pay-as-you-go" revenue source. The need for a more flexible local revenue source led to the enactment of the Mello-Roos Community Facilities Act of 1982.

CHAPTER II: REVIEW OF THE MELLO-ROOS ACT

The special tax authorized by the Mello-Roos Act may be used to finance the construction, expansion, rehabilitation, or acquisition of any real or other tangible property with an estimated useful life of five years or more. The legislative body creating the CFD is permitted to finance any facility it is authorized by law to construct, own, or operate. The special tax may also finance a limited number of services such as police and fire protection services, as long as the special tax is not used to supplant services already provided.

When fewer than 12 registered voters reside in the proposed Community Facilities District (CFD), the landowners are the *qualified electors* with each landowner receiving one vote per acre or portion thereof. The fact that Mello-Roos special tax debt can be authorized by landowners and used as a development tool is the primary reason for its explosive growth during the 1980s. The statewide volume of special tax bond issuance increased from \$8.5 million in 1983 to \$977 million in 1990. In the first six months of 1991, \$458 million was issued, slightly behind last year's pace. Overall, a total of \$3.2 billion in special tax bonds has been issued since 1983. Of this total amount, cities accounted for nearly one-half of the total dollar volume (46 percent), followed by counties (23 percent), school districts (20 percent), special districts (5 percent), public finance authorities (3 percent), and redevelopment agencies (3 percent).

The bulk of the special tax bond issuance during this period was concentrated in the southern California counties of Riverside, Orange and San Bernardino, which is not surprising as these counties collectively represent the fastest growing region of the state. There was also extensive issuance in the Central Valley where development activity has also been strong. In contrast, the more developed areas of Los Angeles County and the Bay Area have issued relatively small amounts of Mello-Roos debt.

CHAPTER III: PUBLIC POLICY ISSUES

In examining the public policy issues raised by the use of Mello-Roos financing, it is important to distinguish between landowner-approved and registered voter-approved financings. Landowner-approved financing represents a significant change in the response of California communities to the infrastructure demands of growth. However, decisions reached in this manner are made without the barometers of public support afforded by more conventional forms of democratic expression. The political acceptance of landowner-approved Mello-Roos financing is assured only when the improved properties within CFDs are purchased, signifying the willingness of buyers to live with predetermined levels of service and tax burdens. By contrast, registered-voter approved Mello-Roos financing is more similar to traditional mechanisms of public finance.

While there are many public policy issues, they can be broken down into a few general categories: expenditure issues, taxation issues, housing affordability issues, and school finance issues.

Expenditure Issues. There are three key expenditure issues related to the use of landowner-approved Mello-Roos financing:

- **Growth and Congestion.** The prevalence of congested public facilities in California suggests that traditional political processes have not been successful in developing policies to address the impacts of growth on public service levels. The landowner vote permits local officials to make decisions, early in the development process, about the mix of taxes and service levels to be provided to developing areas of their communities.
- **Level of Service Standards.** In order to effectively mitigate the impacts of growth on public service levels, some objective system is needed for measuring the likely impacts of individual development projects. The establishment of level of service (LOS) standards for individual program areas permits local officials to generate cost information that can be used for negotiating developer exactions and/or sizing Mello-Roos bond issuances.
- **Concurrency.** Landowner-approved Mello-Roos financing can help localities implement a policy of *concurrency*, which describes the requirement that sufficient capacity be added to the public capital stock, *at the time development occurs*, to accommodate the additional demands of growth. In essence, landowner-approved Mello-Roos financing permits landowners to borrow against the value and tax capacity of their land through the tax-exempt market to pay for the infrastructure needed to serve development. It is the only feasible method of raising a large sum of capital early in the development process to finance the construction of virtually any public facility, while isolating the cost of doing so on the developing area.

Taxation Issues. The Mello-Roos Act provides little guidance regarding the apportionment of the special tax to individual properties, other than to establish the general principle that all properties in the CFD must benefit from the proposed improvements. The Act leaves the rate and method of apportionment of the special tax to the discretion of the local agency approving the levy. The only constraint is that the special tax cannot be an ad valorem property tax as prohibited by Article XIII A of the State Constitution (Proposition 13).

A tension exists between the objectives of designing an equitable or fair tax structure and designing a stable tax structure. Local officials must balance these competing objectives in the design of special tax formulas.

- **Tax Equity.** The objective of tax equity is best served when individual taxpayers pay only for the benefit that they receive from expenditures financed by the CFD. Applying the *benefit principle* to the design of CFD boundaries requires the identification of the geographic region that will benefit from the proposed improvements. For CFDs formed on undeveloped land, that area typically encompasses the properties slated for residential, commercial and industrial development. Applying the benefit principle to the design of special tax formulas requires that similar properties be treated as equally as possible.
- **Tax Base Stability.** The objective of tax base stability is best served by a tax structure that generates a predictable and sufficient stream of revenues. A tax base formed on undeveloped land does not afford the stability of a tax base formed on developed land. The Mello-Roos Act provides several features to improve the security of the tax structure: the ability to capitalize up to two year's interest payments into the bond issuance; the ability to tax developed and undeveloped land at different rates; and the ability to generate debt service coverage of greater than 1.0. These features tend to shift the responsibility for tax payments to those who are most likely to pay: the homebuyer, for residential properties; or the businessperson, for commercial and industrial properties.

Housing Affordability Issues. The housing affordability advantages of Mello-Roos financing are difficult to surmise on a case-by-case basis. Under certain assumptions, Mello-Roos financing may result in lower housing prices, translating into a lower downpayment requirement for buyers. The annual savings will be influenced by the tax-exempt interest rate on the special tax bonds and the transaction costs associated with the bond sale. The strength of the housing market at the time properties are sold will determine the distribution of the special tax burden between the developer and the buyer.

School Finance Issues. Landowner-approved Mello-Roos financing provides a pragmatic tool for school districts to meet the service demands generated by large-scale development projects. However, the isolation of school construction costs over an area the size of a typical CFD raises equity concerns. A broader participation in school facility finance may be justified by the benefits that accrue to society from an educated populace. Moreover, the disparate distribution of CFDs throughout the state might result in inequitable tax burdens and uneven levels of school construction activity. The two-thirds voter approval requirement is a barrier to the widespread use of Mello-Roos financing for school districts in developed areas of the state.

CHAPTER IV: CREDIT ANALYSIS OF MELLO-ROOS SPECIAL TAX BONDS

The real estate boom in California during the late 1980s fueled an explosive growth in the issuance of Mello-Roos special tax bonds. Enthusiasm for Mello-Roos special tax bonds has been tempered, however, by the downturn in the real estate industry which began in late 1989. This chapter explores the credit risks associated with Mello-Roos special tax bonds.

The credit risk inherent in landowner-approved Mello-Roos special tax bonds stems from the divergent dynamics of real estate development and municipal finance. The process of developing real estate is fraught with uncertainties which can affect the timing of construction and the ultimate success or failure of individual projects. The structure of municipal securities, by contrast, is very specific with respect to time; special taxes are payable on certain dates each year and are scheduled at the time of issuance for the term of the bonds--which may be 20 years or more. Much of the activity surrounding a Mello-Roos special tax bond transaction focuses on aligning the divergent dynamics of real estate and municipal finance to the greatest extent possible.

This chapter identifies the following credit risks of landowner-approved Mello-Roos special tax bonds:

- **Regulatory Risk.** If bonds have already been issued and subsequent regulatory decisions reduce the amount of special tax revenue generated by the development project, debt service payments may be threatened. Such decisions include zoning changes, CEQA considerations and building moratoria resulting from water shortages.
- **Construction Risk.** Once all land use entitlements have been obtained, the developer must successfully manage construction activity. In some cases, delays caused by problems with subcontractors, suppliers, and labor could impair the developer's cash flow position and threaten special tax payments.
- **Market Absorption Risk.** If the rate at which properties are developed and sold does not proceed as scheduled, the developer may become financially overextended and delinquent on special tax payments. Although demand for newly developed real estate will primarily depend upon economic conditions, the rate of market absorption may turn on intangible factors such as the ability to produce a *quality* project that correctly targets a market niche.

- **Developer Bankruptcy Risk.** Early in the development process, when the special tax base is highly concentrated, the bankruptcy of a major developer could overwhelm the security features of the special tax bonds and result in default.

All of the credit factors listed above relate to the dynamics of the real estate development process. It follows that if the area is already developed, none of these factors apply. Consequently, Mello-Roos special tax bonds issued in developed areas can be quite strong credits, as long as the CFD includes enough territory to provide for a diversified tax base. The key security feature of special tax bonds issued in developed areas is the ability to provide greater than 1.0 debt service coverage. The cushion between the rate at which the special tax is levied and the maximum rate might provide adequate debt service coverage for all but the most pessimistic taxpayer delinquency scenarios.

CHAPTER V: GUIDELINES FOR MELLO-ROOS FINANCING

This chapter presents guidelines to assist local governments in taking advantage of the benefits offered by Mello-Roos financing while minimizing the associated credit risks and keeping tax burdens reasonable and equitable. The guidelines fall into two categories: **planning guidelines and project evaluation guidelines.**

PLANNING GUIDELINES

The planning guidelines apply to cities and counties and discuss how decisions concerning Mello-Roos financing can be integrated into the land use entitlement process.

Establish Financing Policies In the General Plan. *In order to allocate available debt capacity on a priority basis, the general plan of the city or county should establish a comprehensive policy toward mitigating the service level impacts of growth. The policy should legitimize the funding requirements of all governmental units, including school districts affected by city or county land use decisions.*

Identify Service Standards In the General Plan. *The general plan of the city or county should include level of service standards to provide the framework for mitigating the impacts of growth.*

Distribute Costs on a Project-by-Project Basis. *It is impossible to determine ahead of time how the available debt capacity should be distributed among each local agency serving the development project. However, the LOS standards should be maintained, and the special tax burden should be constrained according to the project evaluation, guidelines below.*

PROJECT EVALUATION GUIDELINES

The project evaluation guidelines apply to all issuers and focus on minimizing the credit risk of Mello-Roos special tax bonds and protecting taxpayers against excessive or inequitable tax burdens. The project evaluation guidelines outline both a procedural approach toward evaluating requests for Mello-Roos financing and criteria for evaluating individual proposals.

Establish a Project Review Committee. *Cities and counties should establish Project Review Committees to review applications from developers for permission to use tax-exempt bond financing for development projects.*

Value-to-Debt Ratio. *To project credit quality, local governments should require a minimum value-to-debt ratio of 3:1.*

Special Tax Limitation. *The maximum special tax rate for landowner approved financings should not exceed one percent (1%) of the anticipated fair market value of each improved parcel upon completion of all public and private improvements.*

Special Tax Inflationers. *Special tax formulas should limit escalator rates allowing annual tax increases in the maximum special tax to two percent (2%) annually.*

Special Tax Coverage. *The maximum special tax should generate at least 110 percent of projected annual gross debt service on the bonds.*

Capitalized Interest Account. *Capitalized interest should be permitted if it improves the credit quality of the special tax bonds and results in lower borrowing costs, benefiting all taxpayers in the CFD.*

Tax Rates on Developed and Undeveloped Land. *Developed and undeveloped land should be taxed at the same rates. The special tax rules should correspond to the adopted land use designations for each parcel. Undeveloped land should be taxed at rates equivalent to tax rates levied on developed properties of the same land use designation.*

Disclosure of Special Tax Lien. *The homebuyer should be made aware of whether or not the special tax will be levied at the same rate for developed and undeveloped properties.*

Bond Reserve Fund. *The bond reserve fund should be set at 10 percent of the principal amount of the bonds or the maximum allowed by law.*

Treatment of Delinquencies. *The foreclosure covenant should be based on the amount of the delinquency; the duration of the delinquency and the condition of the reserve fund.*

CHAPTER I

FINANCING GROWTH: A HISTORICAL PERSPECTIVE

Beginning in the mid-1980s, a growing number of public facilities constructed in developing areas of California were financed under authority of the Mello-Roos Community Facilities Act of 1982. The process by which these bonds are issued typically begins with a small group of developers petitioning a local government for permission to (1) form a community facilities district, (2) approve the levy of a special tax, and (3) authorize the sale of bonds secured by the special tax.¹ The proceeds from the bond sale are used to construct schools, roads, freeway interchanges, water and sewer lines, police and fire stations and other public facility requirements of urban life. The Mello-Roos special tax is secured by liens attached to individual parcels in the development. As homes are constructed and sold, homebuyers assume the liens on the property and the special tax is included on their property tax bills.

While the Mello-Roos Act represents a fairly recent innovation in local government finance, the challenge of meeting the demands of growth is not new to local governments in California. The state's population doubled between 1945 and 1966, growing at an average annual rate of 3.4 percent. The average rate of growth slowed to 1.6 percent annually between 1967 and 1979, but picked up again during the 1980s, averaging 2.4 percent annually over the decade. Moreover, these statewide averages tend to mask the explosive growth which was experienced in various subregions of the state. Riverside and San Bernardino Counties, for example, grew at rates of between six and seven percent annually during the latter part of the 1980s.

In order to fully appreciate the role that the Mello-Roos Act plays in financing growth, it is important to first understand the relationship between growth and capital financing in California and how that relationship has changed over time. Historically, local tax and spending policies in California have been heavily influenced by developments at other levels of government. The federal-state-local fiscal dynamic has been marked by periodic shifts in funding responsibility for infrastructure programs. Examining how funding responsibilities have evolved over time provides a perspective on the emergence of the Mello-Roos Act as a significant tool of public finance, as well as an idea of what we might expect in the future.

Clearly, 1978 was a watershed year for public finance in California. It was the year that the voters approved Proposition 13, which profoundly affected the ability of local governments to respond to growth-induced capital facility needs. In addition, 1978 was the year that federal grants to California began to decline after many years of steady growth. For these reasons, 1978 serves as a useful point of demarcation for our review.

FINANCING GROWTH PRIOR TO 1978

The post-World War II population boom in California would not have been possible without major investments in infrastructure by the federal and state governments. The State of California largely built its systems of highways and universities during the 1950s and 1960s. Beginning in 1956, the federal government began funding 90 percent of the construction costs of the Interstate Highway and Defense System, which helped to open up previously rural areas of the state to development. The federal Central Valley Project and the State Water Project provided the water needed for agricultural production, as well as a burgeoning residential population.

Local government finance during this time was greatly influenced by the physical pattern of development itself. Much of the development was shaped by the speculative purchases of land on the fringe of urban areas. Developers sought and generally received the necessary subdivision approval and rezoning needed for development to occur. The resulting decentralized or *leap frog* pattern of development created service delivery problems, and it was not uncommon for the service demands of rapidly growing areas to exceed the financial or administrative capabilities of existing local governments. In the unincorporated areas of counties, police protection was often limited to *drive-through* patrols by the county sheriffs office and county expenditures on road improvements and maintenance were often very low.

In cases where service delivery to outlying areas was feasible, local governments faced resistance from existing residents who were loath to subsidize service delivery to developing areas. City residents, for example, resented the fact that they paid both a city property tax, which financed their own municipal services, and a county property tax, which subsidized services in the unincorporated areas of the county.

The most common response to the need for higher service levels in developing areas was the formation of special districts. The number of special districts in California grew from 891 in 1950 to 3,293 in 1960, a 270 percent increase.² County Service Areas--dependent special districts which allow counties to isolate the costs of providing a higher level of service than otherwise provided throughout the county--were the most common type of special districts established.³ Residents of developing areas also formed independent special districts (with their own elected boards of directors) in cases where existing local governments were unresponsive to service deficiencies or where a greater degree of political autonomy was desired.

The unincorporated areas of counties had other options for addressing service deficiencies, as well. To the extent that an unincorporated area was lacking in basic utilities such as water delivery or sewage treatment, it could annex to a nearby city which had excess capacity that might be easily extended. The unincorporated area could also undertake a more radical approach and incorporate, although incorporation decisions were generally driven more by the desire for control over land use decisions than by service level concerns.

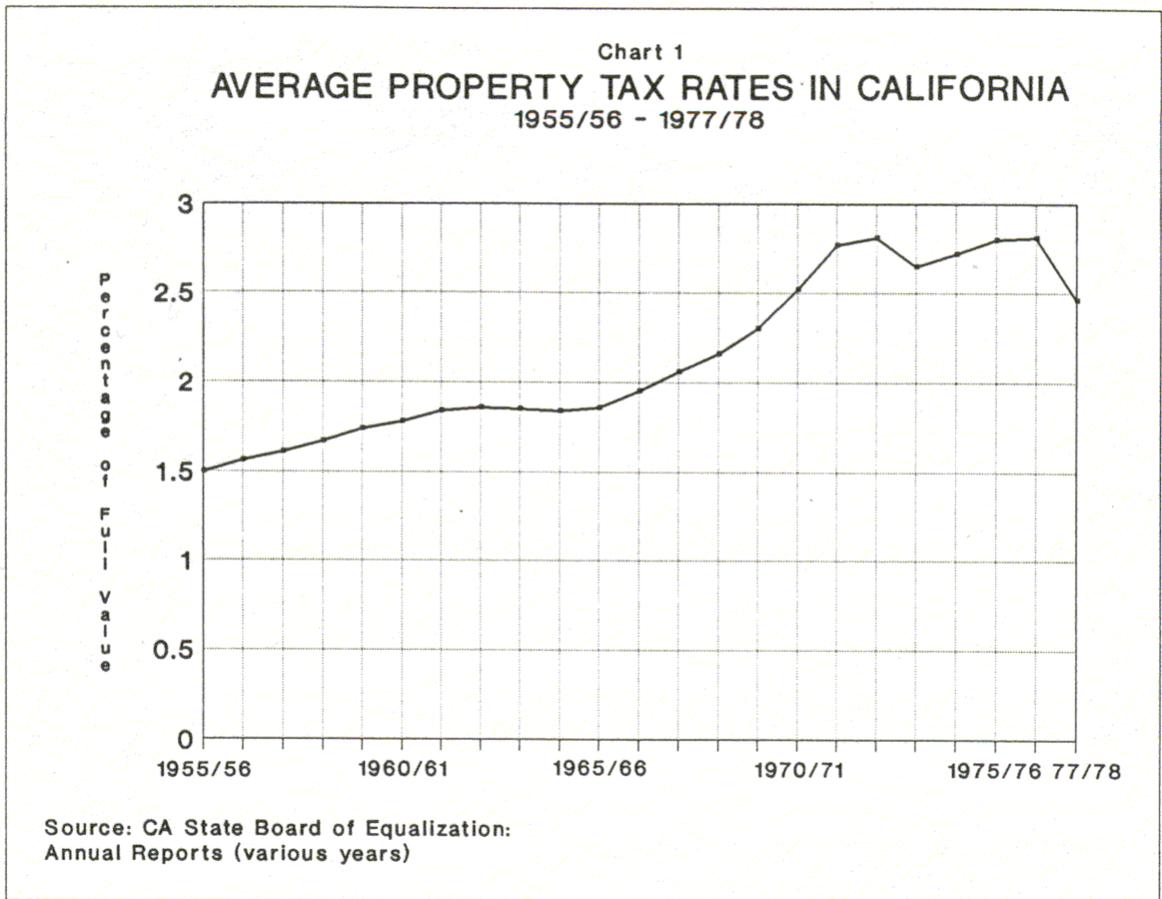
Critics argued that the proliferation of special districts resulted in fragmented service delivery and duplicative administrative overhead. Residents served by a number of special districts found it difficult to hold their public officials accountable. They questioned whether elected officials resisted reorganization of local government in order to protect their own turf. The problems of local government *boundary wars* and urban sprawl led to the enactment of legislation in 1963 which established Local Agency Formation Commissions (LAFCOs). In each county, LAFCOs were assigned regulatory power over the formation and dissolution of governmental boundaries. LAFCOs generally favored absorption of the urban fringe through annexation and discouraged competition between cities and special districts. In addition, LAFCOs were charged with conducting *sphere of influence* studies to determine the ultimate physical service boundaries of each local government.⁴

The Growing Burden of the Property Tax

From a fiscal perspective, the hodgepodge expansion of local governments during this period resulted in upward pressure on property tax rates. Taxpayers paid separate property taxes to support city, county, school district, and special district functions. Each time a new government was formed it generally levied a property tax rate to support its activities. The new property tax rate overlapped the property tax rates levied by the other local governments in its service area. Chart I displays the upward trend in average property tax rates in California from 1955-56 until 1977-78, when Proposition 13 was adopted. As Chart I on page 4 illustrates, average property tax rates increased from 1.5 percent in 1955-56, to a high of 2.81 percent in 1972-73, at which point rates more or less stabilized, until dipping slightly in 1977-78.

The increasing burden of the property tax spawned a political movement to limit property taxes. In 1967, the Legislature enacted the Senior Citizens' Property Assistance Program, under which the state reimburses local governments for property tax relief extended to senior citizens. Senate Bill 8, signed into law a few weeks before the 1968 general election, established the homeowner and business inventory exemptions and eliminated household furnishings and personal effects from the assessment rolls.⁵ In 1972, the Legislature enacted Senate Bill 90, which established a comprehensive system of local government property tax rate limitations, implemented a state mandated reimbursement program for local governments, and reformed school finance to make it less dependent on local property tax revenues.

The property tax limitations imposed by SB 90 were, however, set at historically high 1972-73 tax rates and consequently did not provide much property tax relief, except for school districts. Though property tax *rates* were stabilized in the ensuing years, rapid housing price inflation produced dramatic increases in assessed values. This, in turn, increased the property tax burden, despite the enactment of additional property tax relief measures. Furthermore, the increased property tax collections indirectly contributed to the state's mounting budget surplus by reducing state contributions to school districts under the revenue limit formulas. All these factors came together to create an environment ripe for taxpayer revolt. As a result, the entire property tax system was dramatically reformed by voter approval of Proposition 13 in 1978.



FINANCING GROWTH AFTER 1978

Declining Federal Assistance

Historically, the federal government had subsidized the capital expenditures needed to serve developing areas in two ways. First, the federal government funded generous matching grant programs--often at 90 percent of construction costs--which provided an incentive to construct oversized facilities. The excess capacity built into highways, sewage treatment plants and other public facilities allowed room for growth. Second, the federal government implemented general revenue sharing and block grants with so few restrictions that the funds could effectively be used for any purpose that the recipient government saw fit, including capital expenditures.⁶

While these funding sources permitted local governments to cope with the service level impacts of growth, it is interesting to note that very few of these programs were explicitly designed for that purpose. The federal Interstate Highway and Defense Act of 1956 was motivated, as its name suggests, by national defense concerns, though its salubrious effect on

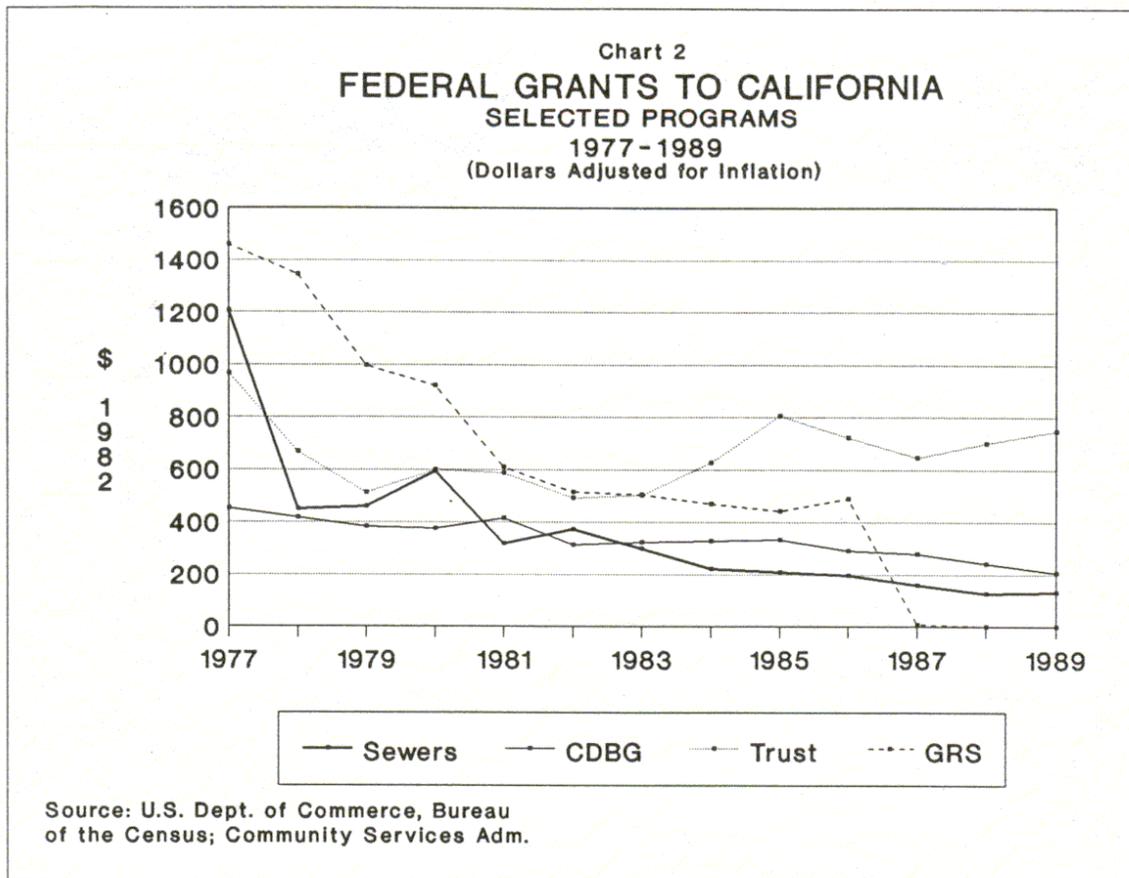
interstate commerce was recognized at the time. The EPA sewer construction grant program was enacted to finance the clean-up of the nation's waterways. The General Revenue Sharing Act of 1972 was enacted to offset a perceived imbalance in the federal and state tax structures, though an antirecessionary public works component was added in the mid-1970s.

The expansion of federal grants to state and local governments during the 1970s was financed by a federal income tax not indexed to inflation and by cuts in defense spending resulting from the winding down of the Vietnam War. By 1978, federal aid constituted a significant amount of local government revenues, particularly for cities. Federal aid as a percent of *own-source* revenue of the nation's 47 largest cities, for example, increased from 2.6 percent in 1957 to 49.7 percent in 1978.⁷ However, in the late 1970s, Congress began cutting tax rates to address the *bracket creep* problem and simultaneously the *peace dividend* began to evaporate. At the same time, concern was growing over mounting federal budget deficits (at levels which seem quaint by today's standards). Consequently, grants to state and local governments were vulnerable to the new fiscal austerity emerging in Washington.

The Reagan policies of tax cuts and defense spending hikes accelerated the devolution of fiscal responsibilities to state and local governments. In 1982, the Reagan Administration consolidated 77 categorical grant programs into 7 new and 2 existing block grant programs, and reduced the overall funding level for the programs by 25 percent. In inflation-adjusted dollars, federal grants to California declined by 25 percent between 1980 and 1989. Beginning in the late 1970s, general revenue sharing was sharply cut back, and by 1987 the program had been completely eliminated.

During the 1980s, grants supporting capital expenditures were particularly vulnerable in comparison to the income support and health care programs which constituted the bulk of federal grants to state and local governments. Chart 2 on page 6 traces the decline in selected federal grant programs that were most likely to have supported local capital expenditures to California between 1977 and 1989. The selected programs include highway trust fund grants and sewer treatment plant construction grants, which directly supported capital expenditures; and general revenue sharing (GRS) and community development block grants (CDBGs), which indirectly supported capital outlay programs.

Another way of looking at the data is to compare the grant levels for the selected programs to the overall level of grants received by California. In 1977, the selected programs comprised 27.5 percent of total federal grants to California; by 1989, the selected programs comprised only 12 percent of total grants to California. Thus, as federal support to states and localities diminished during the 1980s (as measured in constant dollars), the rate of decline for federal programs providing capital assistance was even more precipitous.



Local Responses to Proposition 13

At the same time that the reduced flow of federal funds shifted more responsibility to state and local governments, local governments were forced to cope with dramatic reductions in property tax revenues. Proposition 13 limited the countywide ad valorem property tax rate to one percent of assessed value, plus any amount necessary to repay existing voter-approved debt. In addition, Proposition 13 rolled back assessed values to 1975-76 levels, and limited increases to two percent annually. Reassessments to market value were permitted only when property changed ownership. These changes reduced local government property tax revenues in the 1978-79 fiscal year by \$5.9 billion, or 51 percent, from the previous year's level. Proposition 13 also imposed a two-thirds voter approval requirement for all new special taxes.

The combined reductions in federal funds and property tax revenues more or less ended the practice of subsidizing capital facilities in developing areas with surplus revenues. Though the state government assumed many program costs—mostly in education, health and welfare—the level of local revenues available for discretionary projects declined markedly. The use of new general obligation bonds for capital projects also ceased to be an option, as property taxes could only be raised to support existing voter-approved debt.⁸

Newly formed governmental units could no longer levy a property tax rate to support a higher level of service, as they had prior to Proposition 13. Legislation enacted subsequent to Proposition 13 spelled out procedures by which LAFCOs could reallocate property tax revenues on the basis of service responsibilities transferred from one local government to another. But the formation and dissolution of governmental boundaries became a *zero sum game* with respect to the property tax.

The new era of fiscal austerity did not, however, dampen demands for government spending. With lower levels of general purpose revenues available, the post-Proposition 13 fiscal environment came to be characterized by a greater degree of *earmarking*--the process of identifying a revenue stream to go with a specific spending proposal. Heretofore arcane distinctions between the terms *taxes*, *fees*, and *assessments* took on a practical significance, as resourceful local governments tested the limits of untapped funding sources. As a result, local tax and spending actions were often subject to legal challenge.

The financing of public facilities in developing areas emerged as perhaps the most significant example of the increasing degree of specialization in public finance. As the state entered into a period of rapid growth during the 1980s, new funding sources were needed to replace the old system which relied heavily on local property taxes and federal funding. The principal methods which emerged were developer fees and exactions (including school impact fees), special assessments, and ultimately, Mello-Roos bonds.

Developer Exactions. In the aftermath of Proposition 13, cities and counties began to rely more on their legal authority to require developers to pay for infrastructure improvements as a condition of development approval. The different options for requiring developers to pay for public facilities--the dedication of land to public use, the construction of public improvements, or the payment of developer fees--are commonly lumped together under the term *exactions*. Though developers traditionally had been required to dedicate rights-of-way for streets and to install sidewalks and storm drains, cities and counties began conditioning the approval of development projects on the provision of a variety of public facilities which heretofore had been governmental responsibilities: schools, freeway interchanges, libraries, parks, and so forth.

Cities and counties derive their authority to regulate land use and impose exactions from their constitutional police power to protect the public welfare, as opposed to their corporate power to tax. The courts have held that if a local government has the authority to deny a development project, it also has the authority to approve the project subject to conditions that mitigate the reason for denial. Following this line of reasoning, the adverse impact of development on public service levels represents a threat to the public welfare and is grounds for denial of a development project. The payment of exactions mitigates the adverse impact of the development project on service levels, and represents a condition of approval.

The exercise of police powers must occur within the city or county's territorial boundaries and is subordinate to state law. The state Subdivision Map Act regulates the division of land by cities and counties for purposes of development and authorizes exactions for a variety of public facilities, including public transit, parks (Quimby Act), fire stations, low-income housing, and childcare facilities. The courts have held that cities and counties also have the right to impose exactions for program areas where the Subdivision Map Act is silent. In addition, cities and counties can adopt ordinances that make the granting of building permits a discretionary act

contingent upon the payment of various developer fees. Most developer fees are imposed at the building permit stage.

School Impact Fees. The imposition of developer impact fees for school facilities has been a contentious area of local government finance and the subject of much legislative attention in recent years. Because school districts are not granted police powers under the state constitution, they historically have had to rely on city and county governments--or on a delegation of authority from the state--to impose developer fees. Schools are also expensive to build, comprising a large chunk of the public facility costs of any major development project. Cities and counties, who control the development process, often perceive school districts as *competing* for limited revenues or bonding capacity.

Prior to 1986, school impact fees were primarily used for temporary school facilities under the provisions of SB 201, enacted in 1977. The School Facilities Act of 1986 (AB 2926) redefined the role of school impact fees in meeting the demands of growth. The Act gave school districts the direct authority to charge impact fees for permanent facilities without approval of the city or county governments, in return for accepting a cap of \$1.50 per square foot on residential development and 25 cents per square foot on commercial development. At that time, it was recognized that the capped impact fees would not generate sufficient revenues to meet the demands of growth; the remaining funds would be raised through state general obligation bond sales.

Data from the Construction Industry Research Board indicate that on a statewide basis, the school impact fees authorized by the 1986 Act generated \$528 million in 1988 and \$531 million in 1989, before falling off to \$380 million in 1990 due to the slump in the construction industry. Despite these impressive figures, school population growth has exceeded the projections on which the 1986 agreement was based, and state funding has failed to keep pace.

Faced with chronic overcrowding, school districts are mounting legal challenges to the school impact fee caps specified in the 1986 agreement (which have risen to \$1.58 per square foot for residential and 26 cents for commercial development due to inflation formulas). Three recent court cases indicate that they are having some success. In *Mira Development Corp. v. City of San Diego*, 205 Cal. App. 3d 1201 (1988), the appellate court ruled that a city can deny a request for rezoning because of inadequate school facilities. In *William S. Hart Union High School District v. Regional Planning Commission*, 226 Cal. App. 3d 1612 (1991), the appellate court ruled in favor of two school districts in the Santa Clarita Valley which sued L.A. County to overturn the approval of a 2,500-unit housing project, on the grounds that the county failed to address the school crowding impact of the project. And in *Murrieta Valley Unified School District v. County of Riverside*, the court ruled in favor of a school district which sued the county on the grounds that both its general plan and accompanying EIR failed to address school overcrowding in a fast-growing area in the southwestern part of the county.

In all three cases, the local governments argued that they were preempted by the 1986 School Facilities Act from addressing school capacity issues in their planning processes; and, in all three cases, the courts ruled that the 1986 Act does not prevent local governments from addressing school capacity issues in their planning processes, either by imposing higher fees or taking other mitigation measures (such as establishing a Mello-Roos district). The California Supreme Court declined to review all three cases.

Another recent case, *Lincoln Property Co. v. Cucamonga School District*, upheld a school district's authority to *independently* impose school impact fees without relying on the 1986 School Facilities Act. This case has recently been *depublished* by the court, meaning that it has no precedential value. Nonetheless, the reasoning applied in the case is worth mentioning. According to the appellate court decision, the school districts' authority to independently impose impact fees is derived from Article IX, Section 14, of the California Constitution, which was enacted by initiative in 1972. Article IX, Section 14 permits school boards to “...initiate and carry on any programs, activities, or to otherwise act in any manner which is not in conflict with the laws and purposes for which school districts are established.” The court ruled that this section grants school districts flexibility in addressing school overcrowding caused by development, including the imposition of impact fees as a condition of the issuance of a building permit.

Special Assessments. In addition to developer exactions, the immediate post-Proposition 13 era saw a resurgence in the use of special assessments. Special assessments are charges imposed on property to pay for a public improvement of direct benefit to that property. Special assessments differ from taxes, in that taxes do not have to be tied to a benefit received by the taxpayer. Unlike taxes, special assessments cannot exceed the cost of providing the facility or service.

The special assessment acts had been used extensively in the early part of the century to finance public improvements in rapidly growing cities and irrigation projects in agricultural areas. However, a series of defaults during the Great Depression caused the assessment acts to fall out of favor with local governments. The principal assessment acts date from the early part of the century: the Improvement Act of 1911, which specifies procedures for establishing assessment districts, levying assessments and issuing bonds; the Municipal Improvement Act of 1913, which specifies a procedure for establishing assessment districts and levying assessments, but not for issuing bonds; and the Improvement Bond Act of 1915, which authorizes the issuance of bonds only. Other more recent acts, such as the Landscaping and Lighting Act of 1972, are also used extensively.

Although there are a variety of assessment acts, they all basically follow the same procedural framework. The governing board of the local entity passes a resolution stating its intention to create an assessment district for a specified purpose and to levy assessments on the property owners within the district. The engineering staff then prepares a report describing the project and the amount of the assessment to be levied on each parcel within the district. A notice of public hearing is then published. Special assessments do not require voter approval, although they are subject to the majority protest provisions contained in the Special Assessment Investigation, Limitation and Majority Protest Act of 1931. If owners of a majority of the property in the proposed district protest, the governing board must drop the proposal for at least one year, unless the protest is overridden by a four-fifths vote of the board. If not, the governing board can go ahead and levy the assessment.

Though the distinction between special assessments and taxes had been upheld by a series of court rulings dating from the early part of the century, Proposition 13 prompted a new series of cases which claimed that the growing usage of the assessment acts violated one or more of the constitutional restrictions imposed by Proposition 13. In *County of Fresno v. Malmstrom*, 94 Cal. App. 3d 974 (1979), the court ruled that special assessments levied to pay for the construction of streets in a subdivision are neither ad valorem property taxes nor special taxes. The court held that the special assessment is not really a tax at all, but rather a charge to real property to pay for benefits that the property has received from a local improvement. Therefore, special assessments are not subject to the one percent property tax limitation and the two-third voter approval requirement for special taxes imposed by Proposition 13.

In *Solvang Municipal Improvement District v. Board of Supervisors of the County of Santa Barbara*, 112 Cal. App. 3d 545 (1980), the court held that assessments levied for a parking facility were not subject to the one percent property tax limitation, even though the assessments were partly based on assessed value. The court defined the concept of *special benefit* in the following manner:

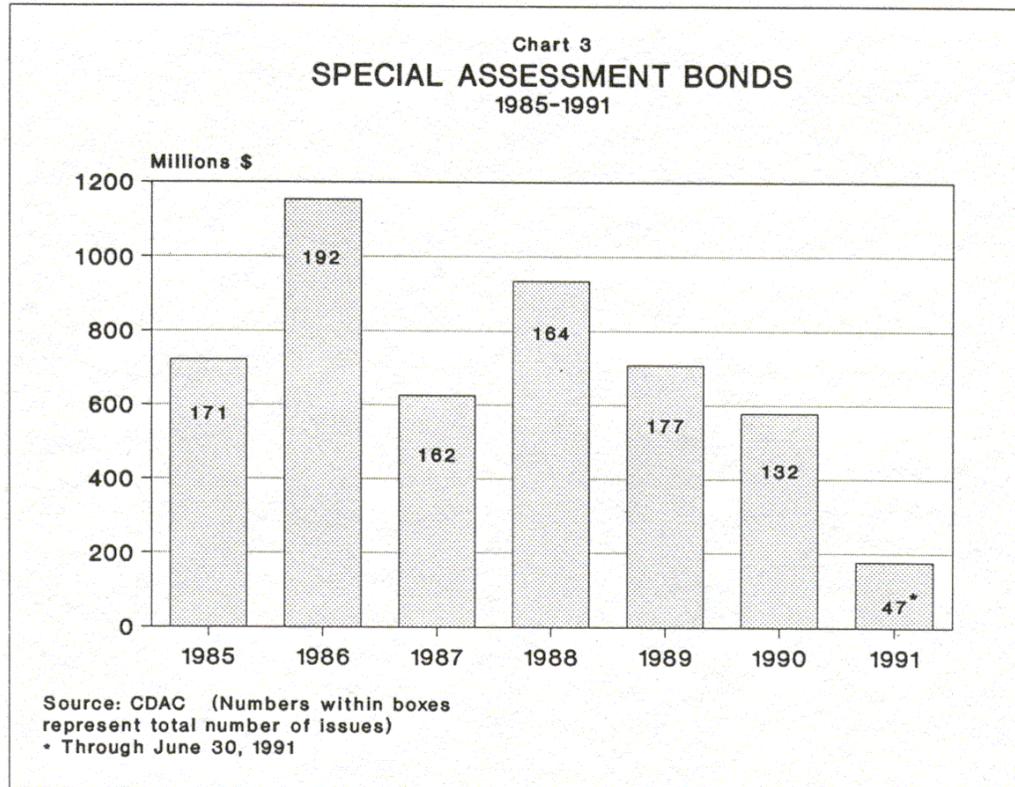
The rationale of special assessment is that the assessed property has received a special benefit over and above that received by the general public. The general public should not be required to pay for special benefits for the few, and the few specially benefited should not be subsidized by the general public.

With the major legal issues settled, the assessment acts began to be used more as a tool for financing the infrastructure needed for new developments--as many of those responsibilities were shifted on to the development industry after 1978. Because landowners ultimately decide whether an assessment district will be formed, the assessment acts can be employed early in the development process, when developers are still the landowners in the proposed district. The developers can petition the city or county to form an assessment district, levy assessments and issue bonds to finance the public facilities required in their development projects. As the homes are sold, homebuyers assume the assessment liens on the property. These features are similar to those found in Mello-Roos districts, a fact discussed in Chapter II.

The use of the assessment acts as a development tool helps to explain the dramatic increase in assessment bond issuance after Proposition 13. Although reliable data is not available, the annual volume of assessment bonds issued in the years prior to Proposition 13 is estimated to have been in the \$20 to \$50 million range. Data from the State Controller's Office indicate that the amount of *outstanding* assessment bonds statewide increased from \$599.5 million in 1977-78 to \$2.05 billion in 1984-85, a 243 percent increase over 7 years.⁹ California Debt Advisory Commission statistics on assessment bond issuances since calendar year 1985 are reflected in Chart 3 on page 11.

The legal distinctions drawn between special assessments and taxes paved the way for the increased usage of the assessment acts in the 1980s. These legal decisions, however, also confirmed the limitations of the assessment acts as a tool for financing infrastructure in new developments. The assessment acts could only be used for projects where a *special benefit* could

be demonstrated. Consequently, the special assessments could not be used to finance a range of public facilities which confer a *general benefit*, but which nonetheless must be constructed to keep pace with growth; such as police and fire stations and most importantly, schools. This left a tremendous gap in the capital financing capabilities of local governments with respect to growth-- a gap which would eventually be filled by the enactment of the Mello-Roos legislation.



SUMMARY

Population growth requires investments in infrastructure -- the physical network of public facilities such as highways, water systems, sewage treatment plants, schools, parks, and libraries. For many years during California's post World War II population boom, the federal and state governments subsidized the construction of these facilities, particularly those which produced a statewide or regional benefit. At the local level, the increased service demands caused by population growth often overwhelmed existing governmental structures, leading to the establishment of new governmental entities. From a fiscal perspective, these demands for service translated into upward pressures on local property tax rates.

The constitutional restrictions on taxation imposed by Proposition 13, coupled with declining levels of federal assistance, required local governments to devise new strategies for financing capital projects. With fewer subsidies available, local governments became adept at identifying previously obscure revenue sources which were not restricted by Proposition 13. Consistent with this trend, developer exactions and special assessments emerged as important tools for financing the public infrastructure in development projects. Because neither of these funding sources legally are taxes, their use was not restricted by Proposition 13. However, practical usefulness of developer fees was constrained by the inherent limitations of a *pay-as-you-go* funding source.¹⁰ Special assessments could only be used for expenditures meeting the legal requirement of *special benefit*. These practical limitations led to the enactment of legislation, the Mello-Roos Community Facilities Act of 1982, which established a more flexible funding source for local governments.

CHAPTER I FOOTNOTES

1 The formation of the Mello-Roos district, the authorization of the bonds and the levying of the special tax also require approval of two-thirds of the *qualified electors* in the proposed district. The Mello-Roos Act defines landowners as qualified electors in the case where a Mello-Roos district is formed in an undeveloped area with fewer than 12 registered voters, with each landowner casting one vote per acre or portion thereof. CDAC staff reviewed the Official Statements of 132 Mello-Roos bond issuances and found that all but five were authorized through landowner votes. The significance of the landowner vote is discussed in more detail in Chapter III.

2 Robert B. Hawkins, Jr. *Self Government by District: Myth and Reality*, pp. 16.

3 County Service Areas are by far the most prevalent form of special district in the state. The most recent data from the State Controller's Office lists 874 County Service Areas in California. See *Annual Report 1988-89: Financial Transactions Concerning Special Districts of California*.

4 The Legislature further strengthened local land use planning laws in 1971 by requiring that all zoning and development decisions be consistent with mandatory general plans prepared by cities and counties.

5 The homeowners exemption, which required constitutional authorization to become operative, was ratified by Proposition IA at the general election in 1968. SB 8 and Proposition 1A successfully derailed a constitutional amendment sponsored by Los Angeles County Assessor Phil Watson to limit property taxes to one percent of the market value of the property within a taxing district. A second Watson initiative--which would have imposed less restrictive property tax limits--was defeated by the voters in 1972.

6 Unless grant formulas include stringent maintenance of effort requirements, the recipient government can *cash out* the grant by substituting grant funds for local revenues which would have been spent on the program anyway--that is, freeing up the local revenues for other purposes. Along this line of reasoning, federal grants for seemingly unrelated programs reduced fiscal pressures and made it easier for local governments to fund capital expenditures out of current revenues.

7 *Own source* revenues include tax revenue, user charges and miscellaneous general revenue. See "Federalism in Transition: 1959-1979" in *Readings in Federalism: Perspectives on a Decade of Change*, Advisory Commission on Intergovernmental Relations, May 1989, p.4.

8 Proposition 46, approved by the voters in 1986, restored the authority to levy an extraordinary property tax rate for general obligation bond measures, subject to two-thirds voter approval.

9 *State Controller's Annual Reports of Financial Transactions of Cities, Counties, and Special Districts*, 1977-78 through 1984-85. Interestingly, cities were responsible for almost all of the increase in outstanding assessments, counties actually declined.

10 In addition, the courts began to require that local governments demonstrate a strict link, or *rational nexus*, between the burden imposed by development and the financial conditions

attached to development approval. The Legislature codified this concept in Assembly Bill 1600 of 1986.

CHAPTER 11

REVIEW OF THE MELLO-ROOS ACT

The Mello-Roos Community Facilities Act of 1982 (the Act) authorizes cities, counties, school districts and special districts to form *community facilities districts* (CFDs) within their boundaries for the purpose of financing infrastructure and certain services. Local agencies are authorized through the CFD to levy special taxes and issue bonds approved by a two-thirds vote of the qualified electors of the CFD. CFDs are formed for funding purposes only: once established, they are governed by the legislative body which approved their formation.

The Act restored a great deal of flexibility to the practice of local government finance in California. Unlike the legal restrictions on the use of special assessments, projects financed through Mello-Roos special taxes do not need to meet a *special benefit* test, because they are financed through a tax, rather than an assessment. And unlike the legal restrictions on the use of developer exactions, a *rational nexus* does not need to be demonstrated between projects financed through Mello-Roos special taxes and the burden imposed by development.

Because the tax authorized by the Act is legally a special tax, it is subject to the two-thirds voter approval requirement for special taxes imposed by Proposition 13. The Act, however, specifies that landowners are the *qualified electors* of the CFD in cases where fewer than 12 voters reside in the CFD. The landowner vote provision, more than any other feature of the Act, is responsible for the rapid growth in Mello-Roos financings throughout the state. Mello-Roos financing has assumed many of the same programmatic functions as special assessments and developer exactions with respect to financing infrastructure in developing areas.

This chapter provides a brief overview of the most significant features of the Mello-Roos Act. First, the chapter reviews the procedural requirements for establishing a CFD, levying the special tax, and issuing bonds. The chapter then presents data on the use of Mello-Roos special tax bonds, including the geographic distribution of bond issuance by county.

PROCEDURAL REQUIREMENTS

Eligible Facilities and Services

The special tax authorized by the Mello-Roos Act may be used to finance the construction, expansion, rehabilitation, or acquisition of any real or other tangible property with an estimated useful life of five years or more. The legislative body creating the CFD is permitted to finance any facility it is authorized by law to construct, own, or operate.

In addition to the construction or acquisition of capital facilities, the following services may be financed under the Mello-Roos Act:

- (1) Police protection services, including but not limited to criminal justice services. Criminal justice services are limited to services for jails, detention facilities and juvenile halls.
- (2) Fire protection and suppression, and ambulance and paramedic services.
- (3) Recreation program services, library services and all costs relating to the operation and maintenance of parks, parkways, open space, museums and cultural facilities.
- (4) Flood and storm protection services, including the operation and maintenance of storm drainage systems.
- (5) Removal or remedial action for the cleanup of any hazardous substance released or threatened to be released into the environment.

The services above can only be provided to the extent that they are in addition to those provided in the CFD before the CFD was created; the Mello-Roos Act cannot be used to supplant existing services.

Proceedings for Forming a CFD

Institution of Proceedings. Proceedings to establish a community facilities district may be instituted in one of three ways:

- (1) The legislative body of a local agency may institute proceedings on its own initiative.
- (2) The legislative body of a local agency may institute proceedings by a petition signed by two of its members describing the boundaries of the proposed CFD and the type of facilities or services to be provided within the CFD.
- (3) A petition requesting institution of proceedings signed by not less than 10 percent of the registered voters residing within the territory, or owners of not less than 10 percent of the area of land proposed to be included in the CFD, may be filed with the clerk of the legislative body. The petition must include the same information as a legislative petition. In addition, a petition initiated by registered

voters or landowners must be accompanied by a fee in an amount which the legislative body determines is sufficient to compensate for all costs incurred in conducting proceedings to create the CFD.

Resolution of Intention to Establish a CFD. Within 90 days of receiving either form of request, the legislative body must adopt a resolution of intention to establish the CFD. The resolution of intention must:

- (1) State that a CFD is proposed to be established and describe its proposed boundaries.
- (2) State the name of the proposed CFD.
- (3) State the type or types of facilities and services to be provided.
- (4) Specify the rate and apportionment of the special tax in sufficient detail so that each resident or landowner within the proposed CFD can estimate the amount that he or she would have to pay.
- (5) Make the finding that the proposed facilities or services are necessary to meet increased demands placed on the local agency as a result of new development or rehabilitation.
- (6) Fix a time and place for a public hearing on the establishment of the proposed CFD which must be not less than 30 days, or more than 60 days after the adoption of the resolution. In addition, the resolution may specify conditions under which the obligation to pay the special tax may be prepaid.

Report Preparation. At the time of the adoption of the resolution of intention, the legislative body directs its staff to prepare a report describing the proposed facilities and services, including a cost estimate. Though the legal requirements are minimal, the report can be more detailed, setting forth the rate and method of apportionment of the special tax.

Notice of Public Hearing. A notice of the public hearing must be published once in a newspaper of general circulation in the area of the proposed CFD at least seven days before the date of the hearing. The notice must include the text of the resolution of intention to establish the CFD, state the time and place of the hearing, and state that the testimony of all interested persons or taxpayers will be heard at the hearing. Notice may also be given by first class mail to each registered voter and landowner within the proposed CFD within 15 days prior to the hearing.

The Public Hearing. At the public hearing, protests may be made orally or in writing against the establishment of the CFD, the extent of the boundaries of the CFD, or the furnishing of specified types of public facilities or services. If (1) 50 percent or more of the registered voters residing within the proposed CFD, or six registered voters, whichever is more, or (2) the

owners of one-half or more of the area of land within the proposed CFD file written protest against the establishment of the CFD, the legislative body must abandon the proceedings. If the protests are directed only toward certain types of facilities or services, or against levying a specified special tax, those specific items may be eliminated from the resolution finally establishing the CFD.

At the discretion of the legislative body, the hearing may be adjourned and continued at another time, as long as it is completed within 30 days. If the legislative body makes specified findings, the hearing may be continued for up to six months. At the conclusion of the hearing, the legislative body may abandon the proposed establishment of the CFD or may proceed.

Resolution of Formation. If the legislative body determines to proceed, it must adopt a resolution of formation containing all of the information included in the resolution of intention. The resolution of formation must also make a determination as to the validity of all prior proceedings related to the CFD.

Special Tax Election

After forming the CFD, the legislative body must submit the levy of any special tax to the qualified electors of the proposed CFD at the next general election, or at a special election to be held between 90 and 180 days following the close of the public hearing. Under the provisions of the Act, if 12 or more registered voters reside in the CFD, the registered voters are the *qualified electors*. If fewer than 12 voters reside in the CFD, the landowners are the *qualified electors*, with each landowner receiving one vote per acre or portion thereof. The Act provides for a vote by mail. The levy of the special tax requires two-thirds voter approval. After a successful election, a Notice of Special Tax Lien is recorded with the county recorder.

In the case of a landowner vote, the time and conduct of the election may be waived upon consent of 100 percent of the landowners.

Proceedings for Issuing Bonds

The proceedings to authorize and incur bonded indebtedness parallel the proceedings for the formation of the CFD and the levying of the special tax; requiring a resolution of intention, public hearing and election. The Act permits the proceedings to incur bonded indebtedness to be conducted concurrently with the proceedings to form the CFD and levy the special tax.

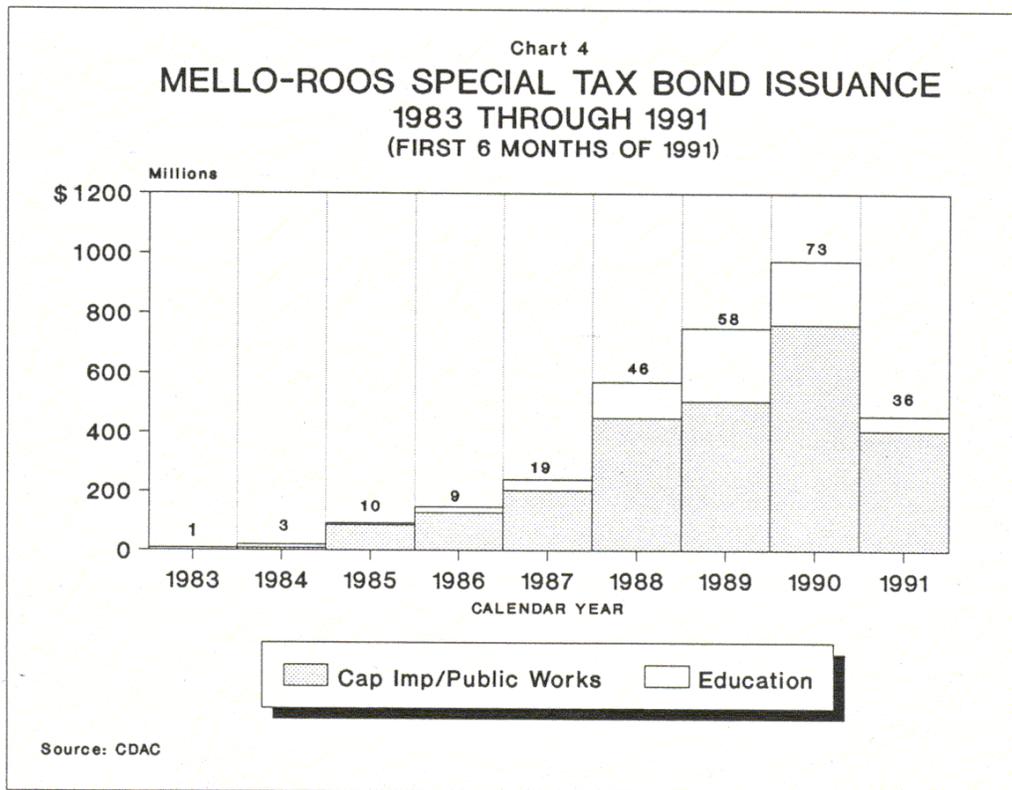
Many Mello-Roos bond issuances have been validated in Superior Court to determine that (1) the special tax is not an ad valorem property tax prohibited by Proposition 13 and (2) the landowner vote does not violate the constitutional requirement of one-person, one-vote. A 30-day statute of limitations applies to legal actions seeking to overturn the levy of a Mello-Roos special tax.

For registered voter-approved CFDs where the one person, one vote requirement is not at issue, the current practice of many bond counsel is to advise their clients that validation is not needed.

DATA ANALYSIS OF MELLO-ROOS SPECIAL TAX BOND ISSUANCE

Purpose of Issuance

Chart 4 displays the volume of Mello-Roos special tax bond issuance from 1983 through the first six months of 1991. The bars on the chart divide the volume of issuance into two categories: (1) capital improvements/public works--a very broad classification which covers the physical network of roads, bridges, water supply, storm drains and other public facilities which are a necessary condition of development-- and (2) education, which consists primarily of K-12 school facilities.



As with most financing innovations, it took the Mello-Roos Act a few years to gain market acceptance, during which time several pieces of clean-up legislation were enacted to address ambiguities in the Act which concerned issuers and municipal bond industry

professionals. The first Mello-Roos special tax bond issue in 1983 raised \$8.5 million for K-12 school facilities in the Mountain View School District in San Bernardino County. By 1986, the volume of statewide bond issuance grew to \$147 million, consisting of nine separate bond issues. The volume doubled between 1987 and 1988, growing from \$240 million (19 bond issues) to \$570 million (46 bond issues). After climbing to \$751 million in 1989 (58 bond issues), the volume peaked at \$977 million in 1990 (73 bond issues). The six-month total for 1991 of \$458 million (36 bond issues) is slightly behind last year's pace.

Geographic Distribution of Issuance

Chart 5 presents Mello-Roos special tax bond issuances by county of origin for the entire eight and one half-year period. As Chart 5 illustrates, Mello-Roos special tax bond issuances have been highly concentrated in Riverside, Orange, and San Bernardino Counties, which have been the fastest growing regions of the state during this time. Issuers in Riverside County raised \$819 million (61 bond issues); issuers in Orange County sold \$728 million (52 bond issues); and issuers in San Bernardino County tallied \$310 million (31 bond issues). Issues in these three counties account for 57 percent of the total dollar volume of Mello-Roos special tax bond issuance statewide for the entire eight and one-half year period.

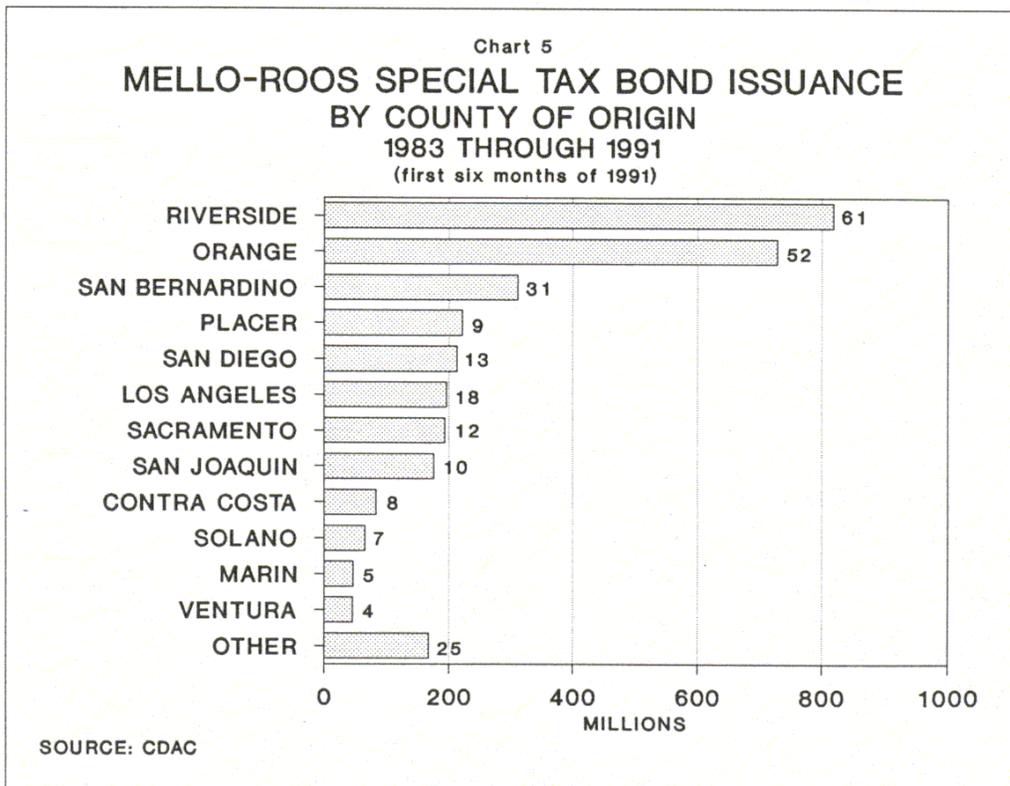
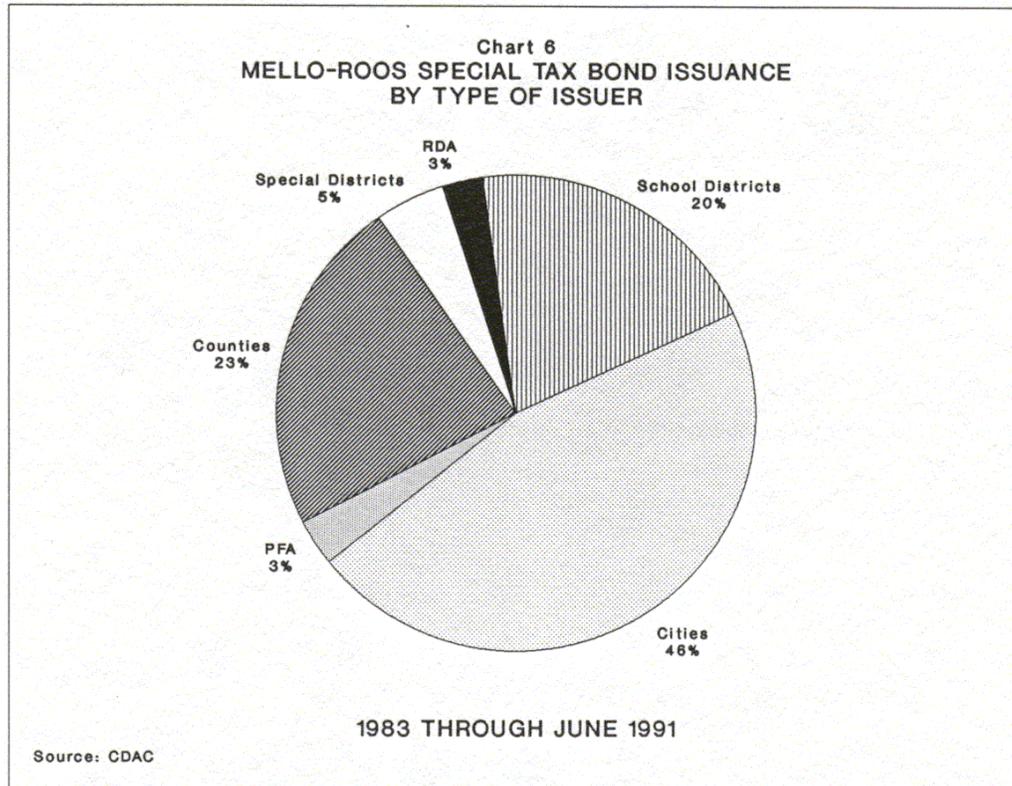


Chart 5 also indicates that the largest concentration of Mello-Roos activity has taken place in Southern California (including San Diego County). Communities in the Central and Northern Valley portions of the state, such as those in Placer, Sacramento and San Joaquin counties, have also been active, with Bay Area jurisdictions placing a distant third. Again, the relatively limited use of the Mello-Roos Act in mature and developed parts of the state speaks to the fact that the preponderance of CFDs have been created by landowner votes in developing and emerging areas.



Issuance by Type of Issuer

Finally, Chart 6 presents data on Mello-Roos special tax bond issuance by type of issuer. Between 1983 and June 1991, there were 255 Mello-Roos special tax bond issues sold statewide, totaling \$3.2 billion. As Chart 6 illustrates, cities account for nearly one-half of the total dollar volume (46 percent). Counties account for nearly one-quarter of total dollar volume (23 percent), followed by school districts (20 percent), special districts (5 percent), public finance authorities (3 percent), and redevelopment agencies (3 percent).

SUMMARY

The Mello-Roos Act may be used to finance the construction or acquisition of virtually any type of public facility, as well as a limited number of services. The formation of the CFD, the levying of the special tax, and the issuance of bonds require two-thirds voter approval and are subject to governmental approval. If fewer than 12 registered voters reside in the proposed CFD, the landowners vote on a one-vote-per-acre (or portion thereof) basis. The vast majority of Mello-Roos special tax bonds issued to date were authorized by the landowner vote.

The majority of Mello-Roos special tax bonds issued to date have been concentrated in three counties: Riverside, Orange, and San Bernardino. The concentration of activity in this part of southern California is not surprising, as this area experienced rapid growth in recent years. The majority of Mello-Roos bonds have been issued for capital improvements and public works purposes with education facilities placing a distant second. Cities have accounted for the largest share of Mello-Roos issuance (46 percent), exceeding the combined dollar volume of counties (23 percent) and school districts (20 percent) since 1983.

CHAPTER III

PUBLIC POLICY ISSUES

The discussion of the procedural requirements of the Mello-Roos Act in the previous chapter does not shed light on the policy considerations and political realities which ultimately shape decisions concerning its use. In examining these issues, it is important to distinguish between landowner-approved and registered voter-approved Mello-Roos financing. Landowner-approved financing represents a significant evolution in the response of California communities to the infrastructure demands of growth. Registered-voter approved financing, by contrast, shares more in common with traditional mechanisms of public finance. This chapter focuses on landowner-approved Mello-Roos financing, due to its unique nature and the fact that it accounts for the vast majority of outstanding Mello-Roos debt in the state.

Because proceedings to form CFDs are, for the most part, initiated by developers working closely with local government officials, it follows that decisions to use landowner-approved Mello-Roos financing are a product of negotiations between these two parties. From the developer's perspective, landowner-approved Mello-Roos financing offers two main advantages. First, it provides a long-term, fixed-rate source of tax-exempt financing. Second, the special tax formulas which support the CFD's expenditures can be designed to keep the holding costs on undeveloped property low.

From the perspective of local officials, landowner-approved Mello-Roos financing presents an opportunity to raise a large sum of capital at once, permitting needed public facilities to be installed more quickly than if construction were to wait for a sufficient amount of developer fees and other revenue to accumulate. Installing public facilities early in the development process reduces the likelihood of future congestion problems and may even result in lower construction costs, to the extent that future rights-of-way disputes and eminent domain proceedings are avoided. In the final analysis, local officials may be swayed by the desire to avoid costly, and often unsuccessful, campaigns to secure two-thirds voter approval for future bond proposals.

Whatever their respective motivations, the negotiations between developers and local officials are likely to focus on two key issues: (1) identifying the public facilities needed to serve the development project; and (2) deciding who will pay for them. These two issues are really not unique to Mello-Roos negotiations--in some form they are at the heart of most matters of public finance. What distinguishes landowner-approved Mello-Roos financing from more traditional tools of public finance is the political process by which tax and spending decisions are determined.¹

Tax and spending decisions of local government traditionally are determined through conventional democratic processes: either directly through referendum or indirectly through the budgetary actions of elected officials. For example, the voter approval requirement for general obligation bond measures allows voters to decide whether the benefits that they will derive from a proposed public works project outweigh the costs of the required tax levy. It should be noted that the same dynamics apply to Mello-Roos financings approved by the registered voters in developed areas. In cases where public officials themselves determine tax and spending policy, they are accountable to their constituents, who will both benefit from and pay for their decisions. Both forms of democratic expression provide some assurance that the resulting tax and spending policies will be supported by the electorate.

By contrast, landowner-approved Mello-Roos financing requires that public officials decide important questions of tax and spending policy *before* the ultimate taxpayers (and beneficiaries) arrive in the community. The ultimate taxpayers are not able to influence the decision directly, by voting, or indirectly, by making their preferences known to their elected representatives. Consequently, the political acceptance of the decision to use landowner-approved Mello-Roos financing does not occur until the improved properties in the CFD are purchased.² By purchasing the properties, buyers signify their willingness to live with the predetermined level of service and tax burden. Or potential buyers may find the mix of taxes and service levels be undesirable and move elsewhere. If the developer faces difficulties in marketing the improved properties, the ability of the CFD to meet its debt service payments may be jeopardized.³

The public policy issues surrounding the use of Mello-Roos financing are discussed below.

EXPENDITURE ISSUES

Though the ultimate residents may not influence the decision to use landowner-approved Mello-Roos financing, the public officials responsible for the decision will be influenced by the residents of developed areas adjacent to the development project. After all, the existing residents are their constituents. And the existing residents are more likely to be concerned about the negative impacts of growth on their own service levels--the familiar problem of congestion--than about the level of service provided to newcomers.

Growth and Congestion

When public facilities such as schools, highways and parks become congested, the costs of growth are no longer limited to developing areas, but are shared by the larger community. Simply stated, congestion occurs when public facilities are subject to use exceeding their capacity limitations. Beyond the point of capacity, each additional user lowers the level of consumption of everyone else. For example, an uncongested freeway can accommodate additional travelers at no inconvenience to existing travelers; however, each additional traveler on an already congested freeway lengthens the commute time for every other traveler. Similarly, each additional student in a crowded classroom raises the student/teacher ratio, diminishing the quality of educational

services received by every other student. The costs of congestion are not tangible budgetary costs, but they do affect the intangible quality of life.

Growth will lead to congestion unless the expansion of the public capital stock is recognized as a necessary, if expensive, consequence of a community's growth. The prevalence of congested public facilities in California, however, suggests that traditional political processes have not been successful at developing policies to address the impacts of growth on public service levels. Certainly, the volatile nature of population growth and real estate development poses challenges for even the most proficient planning departments. It is difficult to develop traditional five-year or ten-year capital improvement programs with any degree of certainty when the demand for public facilities is subject to dramatic shifts. To some extent, the evolution of funding sources which are tied to development activity, such as developer fees, has allowed for the gradual expansion of public facilities to accommodate the incremental impacts of growth.

The problem tends to be more pronounced for larger, more regional public facilities, such as highways, water supply systems and sewage treatment plants, which must be expanded in large amounts and at discrete intervals due to the economies of scale in production. These spending decisions present public officials and their constituents with less than desirable choices: (1) build the optimally sized facility for present needs at the lowest cost to existing residents--but face the prospect of future congestion costs; or (2) build oversized public facilities to accommodate growth--at an added expense to existing residents.⁴ There are several factors working against the construction of oversized facilities. First, California's two-thirds voter approval requirement for most bond measures and budget acts presents a considerable obstacle for proponents of government spending. It is difficult enough to convince two-thirds of the voters to build an optimally-sized public facility to serve existing residents--much less an oversized one for future users. Second, voters are generally reluctant to subsidize the public costs of growth. (To some extent, this concern can be mitigated through bond financing, which spreads the cost of the facility over its useful life). Finally, the oversizing of public facilities may actually encourage growth, which is the anathema to residents of many areas of the state.

For many years prior to Proposition 13, the flow of funds from the federal and state governments, along with surplus property tax revenues at the local level, obscured the relationship between development decisions and public service levels. However, the decline in intergovernmental grants, along with the enactment of constraints on local spending, has caused the link between growth and public service levels to grow clear in the minds of public officials and voters alike. Mello-Roos financing represents one method of assigning new development the responsibility of maintaining reasonable public service levels.

Level of Service Standards

In order to effectively mitigate the impacts of growth on public service levels, some objective system for measuring those impacts is needed. Otherwise, public officials will have no way of knowing what additional public expenditures are necessary. The most practical approach to this problem is to establish level of service (LOS) standards for individual program areas.

Levels of service are the outputs of government; whereas taxes, fees and assessments are the inputs to government; LOS standards quantitatively represent the community's desired service levels for the full range of municipal services to be provided.

A good example of an LOS standard is the classification of roadway conditions developed by the Institute of Transportation Engineers. The classification system measures the number of vehicles traveling on a roadway against the roadway's capacity. The six levels of service range from *A*, for the highest level of service, to *F*, for the lowest level of service. For example, a city might establish a peak hour LOS of *D* for arterial roads and interchanges and *C* for city streets. Other examples of LOS standards are requirements that neighborhood parks be provided within one-half mile of all dwelling units; defined maximum response times for fire stations; acceptable probabilities of flooding for storm drainage facilities; and established open space standards on an acreage per capita basis. In general, the establishment of LOS standards is an iterative process, as higher service levels must be balanced against financial reality and the aesthetic implications of constructing larger public facilities.

Levels of service measure the relationship between the capacity of public facilities and the intensity of their utilization. Planning departments often conduct studies to estimate the demands that development projects and different land use densities place on the community's infrastructure. For example, single family households generate more *vehicle trips* per household on area roadways than households in multifamily apartment buildings, because of higher average family size and a higher incidence of vehicle ownership. Some more sophisticated planning departments further refine their estimates of demand through the use of computer software that actually simulates the impact of development projects on area traffic patterns, allowing the identification of likely bottlenecks.

Generating information at this level of detail permits localities to identify the incremental impacts that individual development projects will place on the community infrastructure. Engineers can use this information to develop cost estimates for projects that are needed to add sufficient capacity to public facilities, so that LOS standards may be maintained. The cost estimates provide a framework for negotiating developer exactions and/or sizing Mello-Roos bond issuances. If Mello-Roos financing is used, the special tax consultant can use the cost estimate, along with the more detailed data on the demands generated by different land uses, as the basis for apportioning the special tax to individual properties in the development project.

Whatever form of financing is used, some expenditures will be needed for entirely localized facilities, such as streets and sewer lines, which will serve only the development project. Other expenditures will be needed to add capacity to more regional facilities, such as highways and recreational facilities, so that communitywide service levels can be maintained. The distinction between localized and regional facilities is not clear cut; it depends on the scale of the development project in question. Large development projects, for example, might generate enough students to fill entire schools. Smaller development projects might only require additional capacity at existing schools. In either case, LOS standards permit the impact of the development project to be estimated and consequently, mitigated. (LOS standards are, in fact, a necessary component of a legally defensible schedule of developer fees.)

Concurrency

One response to the problem of growth and congestion currently gaining popularity in planning circles is the policy of *concurrency*. The term concurrency describes the policy of requiring that sufficient capacity be added to the public capital stock to accommodate additional demands *at the time development occurs*. The policy of concurrency explicitly recognizes the time dimension to public expenditure decisions and, in effect, states that growth will not be permitted to congest public facilities. A concurrency policy can apply to the entire range of municipal services: transportation, education, water, sewer, parks, libraries, and so on.

Clearly, a policy that promises an end to the problem of congestion has an undeniable political appeal. In fact, concurrency is one of the central components of the State of Florida's Growth Management Plan. However, concurrency raises significant implementation challenges which must be addressed if the policy is to be more than exhortative in nature. These challenges involve (1) the need to coordinate the planning activities of different governmental agencies and (2) the matter of paying for the infrastructure installed at the time of development.

The main planning barrier to implementing a concurrency policy occurs when development projects place a burden on a range of public facilities that are the responsibility of different governmental agencies. Development projects approved by the city or county government will ultimately be serviced by school districts, transportation districts, water districts and other governmental units--in addition to the city or county itself. For the most part, the planning functions of all the affected governmental units are not coordinated to the degree necessary to mitigate the service level impacts of growth.⁵ This topic is discussed at more length in the *Planning Guidelines* in Chapter V.

Even if the planning activities of different governmental agencies are coordinated, the policy of concurrency has important implications for the timing of public decisions on tax and spending policies for developing areas. In order for concurrency to be implemented (and LOS standards maintained), public facilities must be installed *concurrently* with development--which means that decisions concerning what to construct and how to pay for it must be reached before the ultimate residents of the development project arrive. Given the general reluctance of voters to subsidize the public costs of growth, local officials will try to isolate costs on the developing area, which leads to a reliance on the funding sources described in Chapter I: developer exactions, special assessments, and Mello-Roos special taxes. It is no longer feasible to provide broad-based subsidies for the initial endowment of infrastructure in most development projects, as was common practice prior to Proposition 13.

In summary, the policy of concurrency requires local officials to balance somewhat divergent goals. Their constituents want the service level impacts of growth to be mitigated, but they do not want to subsidize the costs of doing so. Viewed in this light, the advantages of landowner-approved Mello-Roos financing come into sharper focus. Landowner-approved Mello-Roos financing essentially permits landowners to borrow against the value and tax capacity of their land, through the tax-exempt market, to pay for the infrastructure needed to serve development. It is the only feasible method for raising a large sum of capital early in the development process to finance the construction of virtually any public facility, while isolating the cost of doing so on the developing area.

TAXATION ISSUES

For the reasons outlined above, Mello-Roos financing presents an attractive financing option for addressing infrastructure costs in developing areas. However, the exhaustive process of establishing LOS standards and identifying the service level impacts of individual development projects may leave local officials with little taste for the technical aspects of Mello-Roos financing--designing special tax apportionment formulas and structuring bond issuances. It is tempting to turn these matters over to the financial professionals. But these technical matters raise important public policy questions which are appropriately decided by public officials. While not denying the need for competent technical assistance, it is important to remember that the decisions reached at this juncture will shape the tax burdens of future residents for the next 20 to 30 years.

At the outset of this chapter, we identified “...*who will pay*,” as one of the key issues to be decided in negotiations between developers and local officials. In a broad sense, Mello-Roos financing requires development to pay its own way, as the boundaries of CFDs are typically drawn around tracts of undeveloped or partially improved land slated for development. Yet, the special tax formulas applied within the CFD boundaries can shift the tax burden from developers to the purchasers of the improved properties. The special tax formulas will also affect the distribution of the risk associated with the development process between landowners and investors, which in turn affects the price that the issuer receives for the bonds (the cost of capital). These are all important revenue issues that deserve the attention of local officials.

This section examines the issue of tax equity as it relates to Mello-Roos financing (i.e., the objective of designing a fair tax structure). The objective of equity, however, sometimes conflicts with the need to structure a special tax flexible enough to accommodate the uncertainties of the development process, which is discussed later.

Tax Equity

All those affected by the development process--local governments, developers, new homebuyers and existing residents--would agree that the public facilities required in developing areas should be paid for in an equitable manner. Of course, unanimous opinion tends to break down when the merits of specific tax and spending proposals are debated. The goal of equity or fairness is easy to agree upon in principle, but difficult to agree upon in practice.

The Mello-Roos Act provides little guidance regarding the apportionment of the special tax to individual properties, other than to establish the general principle that all properties in the CFD must benefit from the proposed improvements. The Act leaves the rate and method of apportionment of the special tax to the discretion of the legislative body of the local agency

approving the levy. The only constraint is that the special tax cannot be an ad valorem property tax as prohibited by Article XIII A of the State Constitution (Proposition 13). Consequently, local agencies are responsible for ensuring the design of equitable special tax formulas in the course of their negotiations with developers. To the extent that attention is focused exclusively on the types of facilities and the level of service to be provided, the equity of the special tax formula may be overlooked.

The academic literature identifies two basic principles of equity in taxation--the ability-to-pay and the benefit principles. Taxes levied under the ability-to-pay approach are levied, not surprisingly, according to some measure of the individual's ability-to-pay, such as income or wealth. The rationale for ability-to-pay taxation is that taxpayers should contribute to the funding requirements of government according to their financial abilities. Ability-to-pay taxes serve the redistributive objectives of government.

The usefulness of the ability-to-pay approach as a tool of *local* tax policy is constrained by the mobility of taxpayers across local boundaries. To the extent that an individual local government pursues such a policy, the group of taxpayers called on to subsidize governmental activities would be expected to migrate over time to friendlier territory. Ability-to-pay tax policies are more effectively carried out by higher levels of government--as the ability of taxpayers to avoid paying redistributive taxes naturally declines as the size of the taxing jurisdiction increases. It follows that most redistributive activities, such as public welfare and medical assistance programs, are carried out, or at least financed, by higher levels of government.

Under the benefit principle, taxes are levied in proportion to the benefit received from public expenditures on goods and services. The fairness of a particular tax structure depends upon the nature of benefit conferred by the good or service being financed. In practice, the benefit approach allows tax and expenditure decisions to be resolved simultaneously. Placing a bond measure on the ballot, for example, allows voters to decide whether the benefit of a proposed project is worth the cost of the required tax levy. The rationale for benefit taxation applies particularly well to those public expenditures which add value to property. Insofar as the construction of streets, lighting, sidewalks and sewers adds value to property, it seems fair to charge the benefiting property owners. For these reasons, the benefit principle is generally considered to be the operative model of equity for local government finance.

While the logic behind the benefit principle is compelling, its usefulness in shaping tax policy depends upon the extent to which the benefits conferred by public expenditures can be identified and imputed to individual taxpayers. With respect to Mello-Roos financing, this involves drawing the CFD boundaries and apportioning the special tax.

Drawing CFD Boundaries. Applying the benefit principle to the design of CFD boundaries requires that the taxing jurisdiction (the CFD) be coterminous with the area benefited by the public improvements. In some cases, benefits conferred by public improvements are highly localized, as with streets, lighting, sewers and sidewalks. The benefiting properties are typically adjacent to or abutting the improvement. Other public facilities confer benefits over broader areas, such as arterial roads, regional parks, and as sewage treatment plants. Though the

benefits conferred by these regional facilities are distributed more broadly, they are subject to spatial limitations; in other words, the benefits decline precipitously or diminish altogether as you move farther away from the facility. The challenge is to correctly identify the *geographic region of benefit*.⁶

The fact that most CFDs are formed on undeveloped land considerably simplifies the task of drawing equitable CFD boundaries. The landowners initiating the proceedings to form a CFD are typically the ones who stand to benefit from its formation. The properties slated for residential, commercial and industrial development form the boundaries of the CFD. However, even in these cases there may be benefit spillovers. For example, in some instances, not all the beneficiaries may be included in the CFD; in other cases, the CFD may include properties that do not benefit from all of its expenditures.

It is a more complicated undertaking to correctly identify the geographic region of benefit for CFDs formed in developed areas. In the midst of an urban setting, exactly where do the benefits conferred by more regional facilities terminate? In addition, political considerations are likely to affect the design of the CFD, given the difficulty of obtaining two-thirds voter approval. The flexibility afforded by the Act in the design of boundaries can also be used to exclude uncooperative property owners, even though they might stand to benefit from the improvements ultimately financed by the CFD.

The flexibility of the Mello-Roos Act also extends to adding future beneficiaries to the CFD and more narrowly assigning costs within a district. For instance, in the event that future development projects wish to benefit from the public improvements financed through the CFD, the Act specifies procedures for annexing property to a CFD. If the new development wishes to utilize only some of the public facilities financed through the CFD--school facilities, for example--the Act permits the developers to negotiate with the CFD to pay fees in lieu of a special tax.

The Act also provides for the establishment of *improvement areas* within CFDs for the purpose of financing public facilities which benefit only a portion of the CFD. The voters in each improvement area authorize debt separately from the larger CFD to finance these improvements. In effect, each improvement area operates as a CFD within a CFD. Improvement areas are useful for isolating the infrastructure costs of multiphased projects. By forming improvement areas, each phase of the development pays for its own infrastructure. The larger CFD can be used to pay for facilities that confer benefits throughout the CFD.

Apportioning the Mello-Roos Special Tax. Once the boundaries of the CFD are determined, the next step is to apportion the special tax to individual properties within the CFD. A strict application of the benefit principle would require that the special tax be apportioned to individual properties on the basis of the benefit-received from the expenditures financed through the CFD. The fact that some public facilities confer *general* rather than *special* benefits does not diminish the validity of the benefit principle as the basis for apportioning the special tax. As long as the distribution of general benefits throughout the CFD is more or less identifiable, a special tax formula can be developed that treats similar properties as equally as possible. The benefit principle is grounded in economic theory and is not as rigid as the legal tests of *special benefit* which apply to the special assessment acts.

The most common tax base used for Mello-Roos special tax formulas is real property, both land and structures. Insofar as the construction of public facilities adds value to properties in the CFD, real property is a logical tax base. Under the constraints imposed by Proposition 13, the special tax cannot be apportioned on the basis of the value of real property. Rather, the indices used to apportion Mello-Roos special taxes tend to be similar to the indices used to apportion special assessments. Typically, these indices are based on the physical dimensions of the property itself. For example, the special tax may be levied on the basis of acreage or the square footage of a dwelling. The physical dimensions of the property serve as a proxy for the benefit conferred by the public expenditures financed through the CFD.

Other special tax formulas are based upon more direct measurements of infrastructure usage, such as vehicle trips generated per dwelling unit or gallons of water consumed per dwelling unit. Such formulas approximate the relationship between the infrastructure funded and usage, and as such represent an application of the benefit principle.

Tax Base Stability

As outlined above, tax equity is an important objective in the design of Mello-Roos special tax formulas. But it is often not the controlling objective. Of no small concern to local officials and municipal bond investors is the fact that a tax base formed on undeveloped property does not offer the stability of a tax base formed on developed property. Thus, it is also important for local officials to pursue the objective of generating a sufficient and predictable revenue stream when designing special tax formulas.

During the initial stages of development, the special tax base is typically concentrated in the hands of a small group of landowner/developers--fewer than 12, if the CFD was formed by a landowner vote. Most developers finance their costs of land, labor and materials through short-term construction loans from private lending institutions. Developers may also finance the costs of public infrastructure in this manner, if the locality relies on developer exactions rather than tax-exempt financing. Consequently, most developers are heavily leveraged during the construction phase. Even if the developer has a considerable amount of equity tied up in land and improvements, the developer's source of income is derived from the sale of improved properties, which naturally must wait until construction is completed--or longer if market conditions are slow. Therefore, many developers face cash-flow difficulties during the development process, even though they may own or control millions of dollars in assets.

Conversely, property-related taxes, such as the Mello-Roos special tax, usually represent a small, though not insignificant, claim on the income streams of the *buyers* of improved properties--the homeowner or landlord for residential properties and the businessperson for commercial and industrial properties. To most residential buyers, their home represents their single largest source of equity or savings, and they are not likely to walk away from it to avoid paying their special tax bill, unless they have no alternative. Developers, by contrast, frequently are delinquent in their tax payments, because of the cash flow difficulties described above. When business conditions sour, developer bankruptcies are not uncommon.

Investors understand these dynamics and consequently prefer to see a tax base that relies more on developed property, where possible. This is particularly true during the early stages of development, when the bankruptcy of a major developer might jeopardize the security of the special tax bonds. The Mello-Roos Act includes several features for improving the security of the special tax during the initial phases of development:

Capitalization of Interest. The Mello-Roos Act specifies that up to two years of interest payments may be "capitalized" into the special tax bond issuance. In other words, the bond issuance can be sized to include the first two years of debt service payments, to reduce the tax liability of the landowner/developer during the construction period. By providing a secure source of debt service during the early stages of development, capitalized interest can improve the credit quality of the bonds. Of course, the taxpayers in the CFD will eventually have to pay for funds deposited in the capitalized interest account.

Taxing Developed vs. Undeveloped Land. The special tax formula may further reduce the landowner/developer's tax liability by taxing developed land within the CFD at higher rates than undeveloped land. (Land is considered to be "undeveloped" until a building permit is secured.) There are limits to the amount that the special tax can be shifted between developed and undeveloped land; in no case can the special tax on any parcel exceed the maximum rate approved at the time of CFD formation. Many special tax formulas use undeveloped land as a "shock absorber." Developed land is taxed at its maximum rate, and to the extent that additional revenue is needed to meet debt service payments, undeveloped land is taxed. If developed land generates sufficient revenues to meet debt service payments, undeveloped land is not taxed at all.

Special Tax Coverage. Another characteristic of Mello-Roos special tax formulas is that the maximum tax can be set to provide greater than 1.0 debt service coverage (i.e. the annual tax revenue generated exceeds the required annual debt service). This permits the special tax on nondelinquent taxpayers to be raised, up to the maximum tax, to cover delinquencies. Once the delinquencies are paid in full, the special tax rates are subsequently lowered. Because of developer cash flow problems, a higher rate of delinquencies would be expected on the undeveloped properties, rather than developed properties.

These security features strengthen the special tax structure by reducing the tax burden on undeveloped property during the early stages of development. To the extent that these security features make the special tax bonds issued more marketable, all of the taxpayers in the CFD will benefit from the lower interest costs. There may also be some justification for taxing the initial residents more heavily to pay for large infrastructure investments, such as water supply systems and sewage treatment plants that require large initial investments. Because of the economies of scale in construction, these facilities must be installed in large increments, with enough excess capacity to last for several years. The excess capacity needs to be paid for when it is installed, not when it is needed. Thus, it might be justifiable to ask new residents to pay more for the immediate availability of service.

But the security features of the Mello-Roos special tax bonds can also result in an inequitable distribution of the tax burden if early residents are forced to subsidize the costs of public facilities from which they will receive no real benefit. For example, the different tax treatment of developed and undeveloped land may not give the developers of large projects the incentive to phase-in public improvements that can be installed incrementally, such as streets and water and sewer lines. Rather, it might be advantageous to the developer to install all of these improvements at once, thereby shifting more of the tax burden to developed properties. If developed and undeveloped land are taxed at the same rate, the developer might have the incentive to form improvement areas within the CFD and phase-in streets and water and sewer lines as needed to keep pace with construction activity. In other words, by forming improvement areas, the developer could keep the holding costs on undeveloped property (outside the improvement area) lower.

In summary, the development of special tax apportionment formulas involves a tension between the objective of tax equity and the objective of designing a stable or predictable revenue stream. To the extent that the security features incorporated into special tax formulas result in a lower cost of capital, all taxpayers in the CFD will benefit. If the end result of the tax structure is merely to subsidize developers, the early residents of the CFD may be disadvantaged. The final chapter of this report offers guidelines for reconciling the objectives of tax equity and tax base stability.

OTHER PUBLIC POLICY ISSUES

Housing Affordability

Public debates over the relative merits of different approaches to financing the infrastructure in development projects often focus on the issue of housing affordability. One argument frequently advanced in favor of Mello-Roos financing is that it results in more affordable housing than does a reliance on developer fees. In fact, many local governments require developers, when applying for permission to form a CFD, to estimate the amount by which the price of their finished units will be reduced if they are granted permission to use Mello-Roos financing.

The belief that Mello-Roos financing promotes greater housing affordability emanates from two arguments:

- 1) Developer fees must be recouped through higher housing prices. Mello-Roos financing instead permits infrastructure costs to be financed through annual special tax payments, avoiding the need to raise housing prices.
- 2) By providing access to the tax-exempt market, Mello-Roos financing results in lower borrowing costs. If developer fees are included in housing prices, homebuyers finance these costs at higher mortgage interest rates.

Any examination of this topic must begin by defining housing *affordability*. The question customarily posed on the CFD application forms focuses on the price of *finished housing*. Defining affordability on the basis of housing price alone, however, ignores the higher annual tax burden imposed on properties in CFDs. In fact, private lending institutions evaluate the costs of taxes and insurance, in addition to housing prices, when qualifying prospective homebuyers for mortgage loans. A rule of thumb used by many lending institutions is that mortgage principal, interest, taxes and insurance costs should not exceed 30 percent of the applicant's annual household income.

Using this broader definition of affordability, Table I and Table 2 on the following page present a comparison between the effects of Mello-Roos special tax financing and developer fee financing on housing costs. The figures in Table I compare two houses of equal quality, except that one has \$25,000 in developer fees added onto its price while the other has the same amount of infrastructure financed through annual special tax payments. Table I assumes that the special tax bonds would be financed over 30 years at a tax-exempt interest rate of six percent (6%). The figures in Table I illustrate that the primary affordability advantage of Mello Roos financing, under these assumptions, is the lower down payment requirement, which is determined by the price of the home. In this case, the down payment requirement is \$5,000 less under Mello-Roos financing.

Table 2 maintains the same assumptions, *except* that the interest rate for the special tax bonds is the same as the mortgage interest rate, nine percent (9%). As a result of eliminating the interest rate differential, the annual costs are actually higher under Mello-Roos financing, because less of the infrastructure cost is paid for up front through the down payment. Moreover, because of the higher annual special tax payment, a slightly higher annual income would be needed to qualify for the mortgage loan.

The cost comparisons between Mello-Roos and developer fee financing in Tables 1 and 2 are admittedly simplified. In reality, the transaction costs accompanying a special tax bond transaction would need to be taken into account, as these costs might eliminate any advantage stemming from the tax-exempt interest rate differential.

Incidence of the Mello-Roos Tax. The examples in Table I and Table 2 assume that the developer can simply tack on the cost of the developer fee to the price of the house without affecting its marketability. If that were the case, the developer was not pricing the unit for maximum profit before the developer fee was imposed. In actuality, the developer might not be able to attract a bid sufficient to recover the entire \$25,000. Or if the developer was determined to do so, it might take longer to sell the property, adding to the holding costs on the property. In an economic sense, the question of *tax incidence* comes into play. The term tax incidence is used to describe the shifting of tax burdens between buyers and sellers in a market transaction. There is a distinction between the *legal* incidence of a tax--who has to write the check to the government--and the *economic* incidence of a tax--who bears the burden of a tax in the form of reduced income.

Table 1

HOUSING AFFORDABILITY COMPARISON

Alternative Methods of Financing \$25,000 of Infrastructure

	<u>Mello-Roos</u>	<u>Developer Fee</u>	<u>Mello-Roos Savings</u>
House Price	\$180,000	\$205,000	\$25,000
Down Payment (20%)	<u>\$36,000</u>	<u>\$41,000</u>	<u>\$5,000</u>
Amount of Mortgage	\$144,000	\$164,000	\$20,000
Annual Mortgage (30 yr. 9% Fixed)	\$13,904	\$15,835	\$1,931
Property Tax (1%)	\$1,800	\$2,050	\$250
Insurance (.5%)	\$900	\$1,025	\$125
Special Tax (30 yr. 6% fixed)	<u>\$1,799</u>	<u>\$0</u>	<u>-\$1,799</u>
Total Annual Costs	\$18,403	\$18,910	\$507
Min. Income Req.	\$61,343	\$63,033	\$1,690

Table 2

ALTERNATIVE SPECIAL TAX SCENARIO

No Interest Rate Differential

Special Tax (30 yr. 9% fixed)	\$2,414	\$0	-\$2,414
Total Annual Costs	\$19,018	\$18,910	-\$108
Min. Income Req.	\$63,393	\$63,033	-\$360

Note: The special tax payment is also deductible from the federal income tax.

More obliquely, Table I includes an assumption about the economic incidence of the Mello-Roos special tax: the buyer did not adjust his or her bid downward to account for the higher annual special tax payments associated with the property. The legal incidence of the special tax falls on the buyer, but to the extent the buyer is able to adjust his or her bid price down and still purchase the property, some or all of the economic incidence of the special tax is passed back to the developer, in terms of lower profit on the unit. Conversely, the legal incidence of the developer fee falls on the developer, but the developer may be able to shift the economic incidence to the buyer, as in Table 1.

To further refine the analysis, the legal incidence of the special tax on *undeveloped land* falls on the developer, rather than the buyer. Much like a developer fee, the undeveloped land special tax is a cost of production, and the developer will try to recoup this cost through higher prices.⁸ Consequently, the approach of requiring the developer to pay the entire Mello-Roos special tax lien *at the time of sale--as is being experimented with in the City of Carlsbad--* can be thought of in an economic sense as converting the special tax into a developer fee. (Of course, the legal restrictions governing the use of developer fees would not apply.)

In the short term, the strength of demand for housing will determine how much of the developer fee can be shifted forward to the buyer, or how much of the special tax burden can be shifted back to the developer. In a market characterized by a strong demand for housing, more of the tax burden will fall on the buyer. In a weak market, more of the tax burden will fall on the developer.

In the longer term, the real estate development industry will adjust to the imposition of development-related taxes. Anticipating the eventual imposition of these taxes, developers may bid less for the raw land needed for their projects, passing some of the tax burden back to the owners of raw land. If the developer were unable to pass these costs backward to the owners of raw land or forward to the buyers of improved property, profits would lag and development activity would be cut back. Employment in the industry would decline. The capital previously invested in real estate development would be invested in other, more promising industries. In turn, the smaller supply of developed properties would result in higher average prices, restoring profitability to the industry.

In summary, the housing affordability advantages of Mello-Roos financing are not clear cut. Under certain market scenarios, Mello-Roos financing may result in lower housing prices, translating into a lower downpayment requirement for buyers. The annual savings will be influenced by the tax-exempt interest rate on the special tax bonds and the transaction costs associated with the bond sale. The strength of the housing market at the time the properties are sold will determine the distribution of the special tax burden between the developer and the buyer. The unpredictability of these variables make it difficult to surmise in advance what effect Mello-Roos financing will have on housing affordability. Local governments may ask for this information on application forms, but the responses may not reflect market realities.

Effect of Tax Differences Between Communities on Housing Prices. As a result of the various innovations in public finance in recent years, the modern California real estate market is characterized by a variety of tax differentials between communities--and even between

neighborhoods within communities. Because of the broad fiscal trends outlined in Chapter I, the tax burdens tend to be higher in the rapidly growing areas of the state--the same areas which are responsible for most of the Mello-Roos special tax debt issued to date.

To the extent that these tax differentials fall within the same regional markets, buyers of real estate would be expected to react to these differentials. A home in an established neighborhood with a lower tax burden should be worth more than a home in a new development with a higher tax burden, all other matters being equal. According to economist George Break:

The less significant service differentials are... the more important will differences in local tax burdens are. In well-functioning urban residential markets, tax differences not matched by equally valuable differences in service levels--so-called onerous property tax burden differentials--will be fully capitalized into lower and higher housing values.⁹

With respect to Mello-Roos special tax burdens, the key phrase in the above quotation is "*well-functioning urban residential markets.*" Market participants will only react to tax differentials between properties if they are aware that such differentials exist. Despite clean-up legislation enacted in 1986 and 1988 to promote better disclosure of Mello-Roos special tax liens, CFD residents are often unpleasantly surprised by their property tax bills. As recently as May 19, 1991, a headline in the Orange County edition of the Los Angeles Times read:

New Homeowners Stung by Special Taxes

Levies: *Families in many new developments stagger under the cost of add-on charges for road's and other public facilities. What they had paid in older neighborhoods often quadruples upon moving.*

The article recounted several individual tales of woe, sprinkled with quotes such as, "*When you're a new homeowner, you get caught up in all the excitement and the amount of money involved just doesn't hit you until later...it just doesn't sink in.*"¹⁰

The quote echoes a familiar complaint. The volume of paperwork associated with the typical real estate transaction overwhelms the buyer. The financial consequences of the special tax lien are not fully appreciated until the tax payment becomes due. On the other hand, there is evidence the tax burden imposed by Mello-Roos special taxes has permeated the consciousness of some market participants. *No Mello-Roos* slogans are being sighted on billboards advertising the virtues of development projects which, presumably, do not have special tax liens attached to their properties. While we do not advocate the use of billboards, Chapter V of this report does include guidelines for enhancing the disclosure of Mello-Roos special tax liens.

It should be kept in mind that Proposition 13, rather than the Mello-Roos Act, is primarily responsible for the existence of property-related tax differentials in California. The people who were the subjects of the newspaper article cited above most likely would have faced significantly higher property taxes even if they had moved to older neighborhoods without CFDs. Under the acquisition-based assessment practices instituted by Proposition 13, property is reassessed to market value only when it changes hands. Consequently, people who have been living in the same home for a number of years are likely to pay substantially higher property taxes if they move anywhere else in California. And people who move into CFDs are hit with a double whammy: an ad valorem property tax that has just been assessed to market value, plus the special tax and any assessment liens attached to the parcel. This combination can lead to the quadrupling of property-related tax payments mentioned in the newspaper article above.

Financing School Facilities

As noted in Chapter II, twenty percent of the volume of Mello-Roos issuance to date has been issued by school districts, mostly for K-12 school facilities. During the period of rapid growth in the late 1980s, school districts found that landowner-approved Mello-Roos financing was well-suited to addressing the service demands generated by large scale development projects. Some districts, such as the Elk Grove Unified School District in Sacramento County, were able to receive the necessary two-thirds voter approval to form CFDs in developed areas. In addition, the restrictions imposed on school impact fees in 1986 made Mello-Roos financing that much more attractive.

Mello-Roos Financing Only a Partial Solution. School facility funding does not fall neatly into the scheme of benefit taxation outlined earlier in this chapter. Certainly, students and their families benefit from education in the form of higher earnings potential and increased quality of life. In addition, home prices are affected by the quality of education provided by the local school district. Yet insofar as most of the benefits derived from school facilities accrue to students themselves, the benefits are not confined to a geographic region, as students often complete their education and move away. The geographic indeterminacy of educational benefits can be used as an argument for assigning at least some of the funding responsibility for school facilities to the state government. It is also true that some of the benefits of education are distributed broadly to society, in terms of economic productivity and increased participation in the democratic process. Isolating the costs of school construction over a tax base as narrow as the typical CFD does not account for the benefits accruing to society at large.

An equally compelling argument for broader-based participation can be made on ability-to-pay grounds. There is no clear reason why school facility funding decisions should not be consistent with the *Serrano* paradigm that requires equalization of the operating side of school budgets. After all, school facilities are constructed to facilitate the teaching of students. Educational services require both a capital and operations component. If one applies the equity arguments of the *Serrano* case, the level of spending on school facilities should be independent of local wealth characteristics. While benefit taxation may work fine for more or less generic public facilities such as streets and sewers, school facility funding may warrant the broader participation of society.

Consequently, both the benefit and the ability-to-pay approaches point to some level of state funding. In fact, the state government has assumed at least nominal responsibility for school facility funding in California. However, the state construction program is severely underfunded,

and probably will be for quite some time. Further, it is also questionable from an organizational perspective whether a large state bureaucracy will ever be able to quickly respond to the immediate demands of growth. In light of chronic state funding shortages, the choice facing school districts typically is not between state or local funding; it is between local funding now or state funding later. In many cases, the congestion costs incurred by waiting for state funding may be less desirable than the any inequities caused by isolating construction costs on a small group of taxpayers.

To the extent that state funds are available, Mello-Roos special taxes can provide the local response to a state-local partnership in school facility finance, as is described below.

Interaction With the State Lease-Purchase Program. The state Lease-Purchase Program for school construction is actually a grant program, as the requirement to repay the state was eliminated in response to Proposition 13 in 1978. However, a local match requirement for school districts participating in the program was added as part of the 1986 School Facilities Act. Unlike most government programs, the match requirement was not set at a specific ratio of construction cost. Rather, the match was set equal to the amount of revenue that a districtwide school impact fee, set at the limits prescribed by law, would generate between the time that the project is approved for state funding and the time that construction is completed. The amount actually contributed by the school district varies according to the rate of growth of the school district relative to the number of projects funded.

When CFDs are formed for school construction purposes, the school impact fee is often waived, completely or partially, to avoid "double dipping." State law permits the local match to be contributed through the levy of a Mello-Roos special tax, rather than through school impact fees, as long as the same amount of revenue is contributed. In addition, legislation enacted in 1989 (SB 1528) permits the area within CFDs to be excluded from districtwide local match calculations, if certain conditions are met.

The 1986 School Facilities Act also granted higher priority on state resources to those school districts which agree to contribute 50 percent of construction costs. School districts participating in the "50/50" program are also permitted to project enrollment increases, or ADA, over two additional years for the purpose of qualifying for state assistance. This permits larger or additional projects to be eligible for funding earlier than under the regular lease-purchase program. In addition, by participating in the 50/50 program, school districts are deemed to have met their match requirement, relieving them from the paperwork required to demonstrate fulfillment of that requirement.

School districts may raise the revenues needed to participate in the 50/50 program by any means at their disposal. The formation of CFDs and the issuance of Mello-Roos special tax bonds is a popular method of raising the local share. Under certain circumstances, school districts are eligible to be reimbursed for special tax bonds issued to finance school construction prior to receiving state funds.

SUMMARY

Landowner-approved Mello-Roos financing permits local officials to make decisions, early in the development process, about the mix of taxes and service levels to be provided to developing areas of their communities. However, decisions reached at this juncture are made without the barometers of public support afforded by more conventional forms or democratic expression. The political acceptance of landowner-approved Mello-Roos financing is only ensured when the improved properties within CFDs are purchased, signifying the willingness of buyers to live with predetermined levels of service and tax burdens.

The decision of local officials to authorize the formation of CFDs early in the development process may be motivated by the desire to avoid the traditional problems of growth and congestion. By permitting significant amounts of capital to be raised early in the development process, landowner-approved Mello-Roos financing can help localities respond to the demands of growth while maintaining communitywide service levels. Moreover, the public costs of growth can be isolated on developing areas, avoiding the need for subsidies from existing residents.

In apportioning the special tax to individual properties, local officials must balance the competing goals of tax equity and tax base stability. The objective of equity is best served when individual taxpayers pay only for the benefit that they receive from expenditures financed by the CFD. But the desire for tax base stability may lead to the adoption of security features which tend to shift the; responsibility for special tax payments from undeveloped land to developed land, which may subsidize developers at the expense of homeowners. If these features result in lower borrowing costs, all taxpayers in the CFD will benefit. But these features may also result in an inequitable distribution of the special tax burden.

The housing affordability advantages of Mello-Roos financing are difficult to surmise on a case-by-case basis. Under certain assumptions, Mello-Roos financing may result in lower housing prices, translating into a lower downpayment requirement for buyers. The annual savings will be influenced by the tax-exempt interest rate on the special tax bonds and the transaction costs associated with the bond sale. The strength of the housing market at the time the properties are sold will determine the distribution of the special tax burden between the developer and the buyer.

Landowner-approved Mello-Roos financing also provides a pragmatic tool for school districts to meet the service demands generated by large-scale development projects. However, the isolation of school construction costs over an area the size of a typical CFD raises equity concerns. Such an approach does not account for the benefits that society receives from an educated populace. Furthermore, the uneven distribution of CFDs throughout the state may create inequitable tax burdens and disparate levels of school construction activity from one community to the next.

In summary, the planning advantages offered by Mello-Roos financing are more compelling than other arguments often advanced. Yet, even these advantages must be weighed against the element of speculative credit risk that Mello-Roos financing introduces to the practice of local government finance. The next chapter focuses on the credit risks of Mello-Roos special tax bonds.

CHAPTER III FOOTNOTES

- 1 The analysis of the public decision-making process for landowner-approved Mello-Roos bonds also applies to raw land special assessment bonds.
- 2 The landowner vote signifies the political acceptance of the proposed Mello-Roos financing by the *landowners*, but they are not the ones who will be paying the special tax over the subsequent 20 to 30 years.
- 3 There are a number of reasons, other than an undesirable mix of service levels and taxes, which could cause a development project to fail. These factors are discussed more fully in Chapter IV.
- 4 It should be noted that various demand management strategies, such as ridesharing, peak load pricing, and year-round school calendars may be implemented to help reduce congestion.
- 5 The coordination problem becomes more pronounced when the impact of development decisions on infrastructure programs of state and federal responsibility is taken into account. Local governments cannot exert much influence over state and federal spending highways and major water supply projects, for example. In the area of transportation, some counties take it upon themselves to upgrade stretches of state highways.
- 6 The notion of drawing governmental boundaries around benefit regions is not unique to Mello-Roos CFDs. Most special districts are designed according to the same principle: air quality management districts encompass the terrain of air basins; drainage districts follow topographical drainage patterns and mosquito abatement districts are drawn around mosquito "vectors," to cite a few examples. Special assessment districts, while more restrictive in their permitted uses, are similar to CFDs with respect to the design of district boundaries. In all of these examples, the boundaries are drawn to isolate the cost of service on the taxpayers who benefit from the governmental activity.
- 7 Although voters may be reluctant to subsidize growth, many of these facilities can be constructed with revenue bonds, which don't require voter approval. Public officials must balance antigrowth sentiment against complaints about service deficiencies.
- 8 Insofar as the special tax formulas reclassify property as "developed land" at the time the building permit is issued, the legal incidence for the developed land special tax will also fall on the developer between the time of the building permit is issued and the time the property is sold.
- 9 George Break, *Financing Government in a Federal System*, p. 207.
- 10 Jeffrey Perlman, "New Homeowners Stung By Special Taxes" p. B1 *Los Angeles Times*, Orange County Edition, May 19, 1991.

CHAPTER IV

CREDIT ANALYSIS OF MELLO-ROOS SPECIAL TAX BONDS

The real estate boom in California during the late 1980s fueled an explosive growth in the issuance of Mello-Roos special tax bonds. Local governments were able to raise large sums of capital for immediate construction needs, rather than having to wait for sufficient amounts of developer fees and other revenue to accumulate. Developers benefited from access to tax-exempt financing and the ability to keep holding costs on undeveloped land low. Finally, investors were enticed by higher yields and the knowledge that the special tax bonds were secured by valuable California real estate.

Enthusiasm for Mello-Roos special tax bonds has been tempered, however, by the downturn in the real estate industry which began in late 1989. Economic indicators reflecting the industry's health have been decidedly down for the past 18 months: housing starts, construction industry employment, new home sales, sales of existing homes, and the average prices have stagnated throughout most of California. As inventories of developed properties have risen, the basic assumptions upon which individual Mello-Roos issues were structured are being called into question. The demand for many of these projects has not materialized as expected and the security features of the bonds are being tested. Investors are concerned about the possibility of foreclosure and are scrutinizing land values more closely. Yields for unrated special tax bonds are above pre-1990 levels.

This chapter explores the credit risks associated with Mello-Roos special tax bonds. The credit analysis distinguishes between Mello-Roos special tax bonds issued in undeveloped areas and Mello-Roos special tax bonds issued in developed areas. Because landowners may authorize bonds that are not issued until a CFD is at least partially developed, the distinction between landowner and registered voter approval is not as important in this discussion. Rather, the characteristics of the tax base at the time the bonds are issued provides a better point of demarcation.

This chapter also presents data on Mello-Roos bond yields over the past eight years, which reflects the financial market's perception of the risks associated with the special tax bonds. The chapter concludes by discussing the implications of Mello-Roos special tax bond financing for local debt management practices.

CREDIT ANALYSIS OF MELLO-ROOS SPECIAL TAX BONDS ISSUED IN UNDEVELOPED AREAS

Special tax bonds issued in undeveloped areas are, by definition, landowner-approved. Whatever the planning benefits afforded by these financings, deciding questions of public indebtedness in this manner introduces an element of speculative credit risk to the debt management practices of local governments. Unlike conventional voter approval requirements, the landowner vote is not a referendum on the community's ability and willingness to support capital expenditures or to pay off any debt incurred. At the time the special tax bonds are sold, there is no community to pledge its support; only uninhabited property in some stage of development. As a practical matter, the landowner vote can be considered as a procedural mechanism through which local governments extend tax-exempt borrowing authority to developers. The expression of community support comes from the sum total of individual decisions to purchase the improved parcels and assume responsibility for the special tax liens on the property.

It follows that the credit risk inherent in landowner-approved Mello-Roos special tax bonds stems from the divergent dynamics of real estate development and municipal finance. The process of developing real estate is fraught with uncertainties which can affect the timing of construction and the ultimate success or failure of individual projects. The real estate development industry itself is highly cyclical, sensitive to changing employment levels and interest rates. In addition to economic factors, development projects are subject to substantial governmental regulation and often must contend with a highly charged political atmosphere.

The municipal finance industry, by contrast, operates in an environment that is very specific with respect to time. For instance, the special taxes which provide the security for bond issuances are payable on certain dates each year. Debt service payments are scheduled at the time of issuance for the term of the bonds--which may be 20 years or more. Consequently, much of the activity surrounding a Mello-Roos bond transaction focuses on aligning the divergent dynamics of real estate and municipal finance to the greatest extent possible.

The credit risk of landowner-approved Mello-Roos bonds is greatest during the initial stages of development, when the special tax base is concentrated and the value of land is low relative to its expected value at build-out. At the early stages of development, property ownership may be concentrated in one or a handful of developers, Credit quality will improve as properties are developed and sold, thereby diversifying the tax base and improving the value of properties relative to the amount of debt outstanding on the properties.

The following sections discuss the various components of credit risk in more detail. The sections are arranged in chronological order, corresponding to when the risks are likely to occur in the development process.

Regulatory Risk

Land Use Entitlements. It is not uncommon for Mello-Roos special tax bonds to be issued before all necessary land use entitlements are granted, though some local agencies require such approval as a precondition of issuance. Certainly, a city or county would not approve the formation of a CFD and the issuance of bonds if it did not plan on granting the necessary land use entitlements. But new information or shifting political winds can cause the legislative body to alter the density or type of development, or even cause the abandonment of the project. If bonds have already been issued and subsequent regulatory decisions reduce the amount of special tax revenue generated by the project, debt service payments may be threatened. Moreover, Mello-Roos bonds can be issued by school districts and special districts who have no control over land use regulatory decisions.

The right to develop is considered *vested* when it cannot be revoked by either the local government or the electorate. Historically in California, the courts have favored local governments over developers in disputes over vested development rights. The basic test applied by the courts is that the right to develop has been vested if a property owner obtains a valid building permit and performs substantial work, thereby incurring substantial financial liability in good faith reliance on the permit. (*Avco Community Developers, Inc. v. South Coast Regional Commission*, 17 Cal. 3d. 1976)

In the course of developing real estate, developers frequently incur substantial costs prior to receiving a vested right to develop according to the legal test outlined above. To address the financial risks accompanying such expenditures, the Legislature enacted the Development Agreement Law in 1979, which permits cities and counties to extend vested development rights through formal agreements with developers early on in the development process. A development agreement is an entirely voluntary legislative act which exempts the development project from future changes in land use regulations, such as amendments to general and specific plans, changes in zoning or subdivision ordinances, or new building regulations. As an outcome of the negotiations, the developer may agree to dedicate land or contribute funds beyond what would otherwise be required by law.

While development agreements substantially reduce the regulatory risks associated with Mello-Roos bonds, the legality of development agreement has not been fully tested in court. There is some concern that the courts could rule development agreements to be unenforceable in that they deprive future legislative bodies of the right to exercise their police powers.

In 1984, the Legislature enacted an alternative method for obtaining vested development rights by amending the state Subdivision Map Act to permit developers to process *vesting* tentative subdivision maps. (As mentioned in Chapter 1, the subdivision of land for the purposes of development and sale must comply with local subdivision ordinances enacted pursuant to the state Subdivision Map Act). Approval of a vesting tentative subdivision map confers the vested right to develop in compliance with the ordinances, policies and standards in effect at the time the map is recorded. The vested right to develop terminates if the final subdivision map is not recorded prior to the expiration of the vesting tentative map. Once the final map is recorded, the developer has either one or two years, depending on local ordinance, to apply for a building permit.

Growth Control Initiatives. Development projects can also be derailed by voter-approved growth control initiatives, which have been enacted by a number of communities throughout the state. The exact nature of these controls vary. Common approaches include limiting the annual

number of building permits issued, limiting annual population growth, and linking development to the availability of certain types of infrastructure. Likewise, the effect of growth control measures on individual development varies depending on the nature of the growth control measure and whether or not a vested right to develop had been granted prior to the enactment of the initiative. The effect on individual projects can range from outright prohibition to a deceleration of the pace of development.

Three years ago, state legislation was enacted to protect bondholders from the impacts of growth control initiatives. The law provides that if a local agency finds that a growth control initiative is likely to lead to a bond default, the development project should be permitted to proceed, the growth control initiative notwithstanding. The statute has not been tested in court.

Building Moratoria. Earlier this year, localities throughout the state considered imposing building moratoria in response to severe drought conditions. At the time, water supplies were not adequate to meet existing demand, much less to serve the needs of new development. The Elsinore Valley Municipal Water District, in fact, suspended water deliveries to construction sites for 60 days, causing a temporary halt to construction activity.

Unanticipated delays in construction disrupt the efforts at matching debt service schedules to the timeline for the construction and sale of properties. Such delays, if continued indefinitely, could cause developers to become financially overextended. Though the March rains provided a respite from the most recent crisis, the availability of a secure water supply is clearly a variable to factor into the Mello-Roos equation,

CEQA Considerations. At some point prior to construction, a development project of any consequence will be required to determine whether the project will pose a significant impact on the surrounding environment. Under the California Environmental Quality Act (CEQA), local agencies and developers must mitigate any impacts which are of a significant nature, unless the project will provide overriding public benefits which outweigh the impacts.

The process of environmental review and mitigation can be lengthy and this time period does not take into account the many legal challenges which can occur under CEQA and forestall development indefinitely. For example, endangered species may be found within the boundaries of the CFD, potentially jeopardizing the development of certain lands. Consequently, the timing associated with issuing Mello-Roos bonds must be sensitive to potential delays which may come about as part of the CEQA review process.

Construction Risk

Once all land use entitlements have been obtained, the developer must successfully manage construction activity. In some cases, problems with subcontractors, suppliers, labor, inclement weather, or natural disaster can lead to temporary delays in construction. Any such delays can impair the developer's cash flow position and threaten special tax payments.

Moreover, construction activity can uncover problems with faulty soil conditions, hazardous waste and other impediments to orderly development. Such delays, while not necessarily regulatory in nature, have the same consequences for the timely payment of debt service as those outlined in the previous section.

Market Absorption Risk

The term *market absorption* refers to the rate at which properties are developed and sold. Estimates of the rate of market absorption are instrumental in structuring Mello-Roos special tax bond offerings and special tax apportionment formulas. The local government or developer typically commissions a market absorption study to determine a reasonable build-out schedule for the project. The build-out schedule, in turn, allows the appraiser to estimate the discounted cash-flow value of the land, which is instrumental in sizing bond issues and developing special tax apportionment formulas. The market absorption study breaks down the project into its residential, commercial, and industrial components and estimates the demand for each type of land use. The projections of demand are derived from forecasts of employment and real estate activity in the general region of the proposed project.

The market absorption study will help define the potential success of projects using Mello-Roos financing. For instance, the size and diversity of an area's employment base can be used to determine the demand for real estate, especially for housing. Likewise, the prevailing wage rates in a region will serve as a reasonable basis for determining the marketability of housing units priced at various levels. Finally, the rate of market absorption will be influenced by the level of competition posed by existing inventory or planned development which is similar to the project financed by Mello-Roos bonds.

Unfortunately, it is difficult, if not impossible, to precisely forecast business activity for a cyclical industry such as real estate development. In the course of preparing this study we did not systematically review the veracity of the absorption studies prepared for Mello-Roos bond issuances to date. Yet of the handful of studies we did review, none anticipated the current downturn in real estate activity.

Even if absorption studies could accurately predict regional economic activity, however, individual projects can defy broad trends. The rate of absorption may instead depend on intangible factors such as the ability to produce a *quality* project that correctly targets a market niche or on the location of a given project within a region. As a result, good projects can succeed in slow markets. Conversely, poorly designed projects can falter even in robust markets. Thus, it is important that absorption studies be just one means of evaluating the potential risk associated with individual Mello-Roos projects.

Developer Bankruptcy Risk

Whatever the reason for slower-than-expected absorption, debt service payments must be met. The largest development companies in the state most likely have more than sufficient resources to continue uninterrupted debt service payments through a downturn in real estate activity. But other developers, particularly those who are highly leveraged, may not be able to bear the load. In the event of a shortfall of revenue from undeveloped property, Mello-Roos

special tax formulas typically turn to the owners of developed property to pay a backup special tax, up to the amount of the maximum tax rate. After properties are taxed at their maximum rates, the reserve fund can be drawn down, which might cover one to two year's of debt service payments, depending on the level of the reserve and the amount of delinquencies. A bank letter of credit may provide additional security. But if necessary, the courts, upon request of the issuer, will foreclose on the special tax liens to cover delinquent special tax payments. The fact that the property itself provides the ultimate security for Mello-Roos bonds is the reason that a great deal of scrutiny is given to the value of the property relative to the amount of debt outstanding on the property (the value-to-debt ratio) during the structuring of a Mello-Roos offering.

CREDIT ANALYSIS OF MELLO-ROOS SPECIAL TAX BONDS ISSUED IN DEVELOPED AREAS

All of the credit factors listed in the analysis of Mello-Roos special tax bonds issued in undeveloped areas relate to the dynamics of the real estate development process. If the area is already developed, none of those factors apply. As long as the CFD includes enough territory to provide for a diversified tax base, Mello-Roos special tax bonds issued in developed areas can be quite strong credits. If development is only partially complete, some of the credit risks which apply to undeveloped special tax bonds may still be relevant. Generally, a bond issuance cannot receive a credit rating until property ownership becomes diversified and the value-to-debt ratios improve to the range of 8:1 to 12:1.

The key security feature of special tax bonds issued in developed areas is the ability to provide greater than 1.0 debt service coverage. The cushion between the rate at which the special tax is levied and the maximum rate might provide enough debt service coverage for all but the most pessimistic scenarios of future taxpayer delinquencies. In that sense, the credit quality of a special tax bond is similar to that of a general obligation bond, though the special tax bond would still be of the *limited tax obligation* variety.

Moreover, special tax bonds issued in developed areas can provide for an equitable distribution of the tax burden. When the property in the CFD is substantially developed, there is obviously less shifting of the tax burden between developed and undeveloped property. The special tax may be more closely apportioned on the basis of benefit received. Depending on the nature of the expenditures being financed and the size of the CFD, the resulting tax burden may be more equitably distributed under a special tax bond than under a general obligation bond. The tax burden under the general obligation bond financing will be distributed according to the acquisition-based assessment practices imposed by Proposition 13. The distribution of the tax burden on this basis invariably bears no reasonable relationship to the benefits conferred by the expenditure being financed, nor does it measure the taxpayer's ability-to-pay.

Moody's Investors Service, in issuing an A rating to a 517.6 million special tax bond issuance of the Elk Grove Unified School District in 1990, offered the following analysis:

The substantial level of existing development within the district and the extent to which the special tax levied on that development can already provide adequate coverage of peak debt service are critical factors underlying the upper medium grade rating. The district contains an unusually large number of existing taxpayers for a Mello-Roos district and continues to experience significant population and tax base growth. 1

The Elk Grove Unified School District CFD demonstrates some of the advantages of Mello-Roos financing for developed areas. Of course, the Elk Grove Unified School District is the exception to the rule given that they received two-thirds voter approval in a *developed area*. In most cases, the two-thirds voter approval requirement limits the feasibility of special tax bond financing.

FACTORS INFLUENCING MELLO-ROOS BOND YIELDS

As with any investment, the price that investors are willing to pay for Mello-Roos special tax bonds reflects their perception of the degree of risk associated with the revenue stream supporting the debt service. A stream of payments dependent upon the uncertain prospects of real estate development will naturally carry more risk than a stream of payments derived from the tax base of an established community. Because many of the credit risks discussed above are not easily quantifiable or known in advance (even to real estate professionals), investors tend to focus on the following factors:

Value-to-Debt Ratios. As mentioned above, ultimate security for Mello-Roos special tax bonds is the value of the land itself including improvements. A rule of thumb among investors is that the value of land, plus improvements being financed, should be at least three times as much as the value of all outstanding indebtedness on the property. According to a recent report issued by Standard & Poor's Corporation:

In the current contraction, land-backed bonds that are heavily dependent on future development for payment of debt service are seriously exposed. The earliest and deepest declines in land value generally occur on undeveloped land, since it is most directly affected by any slowdown in development.²

In order to receive an investment grade credit rating, the rating agencies generally require value-to-debt ratios of at least 8:1, as well as partial build-out and multiple property owners.

While a 3:1 value-to-debt ratio will not be sufficient to secure a credit rating, it does provide some assurance that foreclosure proceedings would produce enough revenue to pay investors, even if land values decline. As the project develops, the opportunity may emerge for the issuer to refund the issue at a savings. At that point, it may be possible to secure an investment grade credit rating.

Because most Mello-Roos bonds are not rated, the value-to-debt ratio often serves as a proxy for a credit rating. The municipal bond market will generally require a minimum value-to-debt ratio of 3:1. Up until recently, value-to-debt ratios of 5:1 were generally trading in the BBB investment grade range or better.

Credit Enhancements. One way to improve the security and marketability of Mello-Roos bonds is to purchase a credit enhancement in the form of a bank letter of credit (LOC) or bond insurance. As with other types of securities, issuers must weigh the added costs of purchasing the credit enhancement against the savings resulting from a higher credit rating.

A report issued last year noted that issuers have faced difficulties in securing credit enhancements for nonrated bonds.³ Even in cases where credit enhancement was an option for landowner-approved Mello-Roos special tax bonds, it did not reduce borrowing costs. At the time, LOC fees were ranging from 150 to 300 basis points annually, depending on the security of the issue. The yield between an AAA rated credit enhanced bond issue and an unrated issue ranged between 50 and 100 basis points. Consequently, the use of credit enhancements did not make sense from a financial perspective. However, because yields on unrated issues have risen in the past 18 months, as illustrated later in this chapter, credit enhancements for Mello-Roos issues may be more financially attractive in today's market.

One additional means of providing credit security is to require the developer to post a *standby* letter-of-credit. The standby letter-of-credit covers the developer's share of the special tax, rather than the entire special tax base. This provides investors with assurance that principal and interest will be paid during the development phase, particularly during the initial stages when the risk of nonpayment is the highest.

Special Tax Coverage. As mentioned in Chapter 111, Mello-Roos special taxes can be set to provide greater than 1.0 debt service coverage. Investors prefer to see that the maximum tax rate can produce revenues above the level needed to service the bonds. The final chapter of this report provides guidelines on incorporating debt service coverage into the special tax apportionment formulas.

Reserve Funds. Given the uncertainty involved in real estate development, there is a greater chance that there will be a draw on the reserve fund of Mello-Roos special tax bonds than for most other types of municipal obligations. Accordingly, such bond reserve funds are a standard way of protecting investors against possible interruption of debt service payments. Again, the final chapter provides guidelines on establishing bond reserve funds for Mello-Roos special tax bonds.

Developer's Reputation. Insofar as development quality and the financial resources of the developer are major sources of credit risk, investors look closely at the reputation of the development company involved in the Mello-Roos special tax bond transaction. Investors are likely to feel more comfortable with a developer with a proven track record for bringing quality projects on line according to schedule. The quality of the development is important because it helps to ensure high absorption and low vacancy rates. And the reputation of the development company is probably the best standard for predicting the quality of the ultimate development.

ANALYSIS OF MELLO-ROOS BOND YIELDS

Chart 7 on the following page tracks the yields of 212 of the 255 Mello-Roos bonds issued between 1983 and June of 1991. As mentioned above, the yields reflect the market's perception of the risk associated with individual bond issues. Because investors require compensation for risk, they naturally require higher yields for riskier investments.

Chart 7 deserves further explanation. The individual data points on the chart mark the interest rate at which Mello-Roos special tax bonds originally traded. The line on the chart is an index of 10 commonly traded revenue bonds, representing the interest rate at which the revenue bonds were available on the secondary market at the time of the Mello-Roos bond issuances. (The comparison is made between the interest rates for the original issuance of the Mello-Roos bonds and secondary market offerings for the revenue bonds.) The bars on the chart represent the interest rate spread (at a given point in time) between original Mello-Roos special tax bonds and bonds included in the revenue bond index.

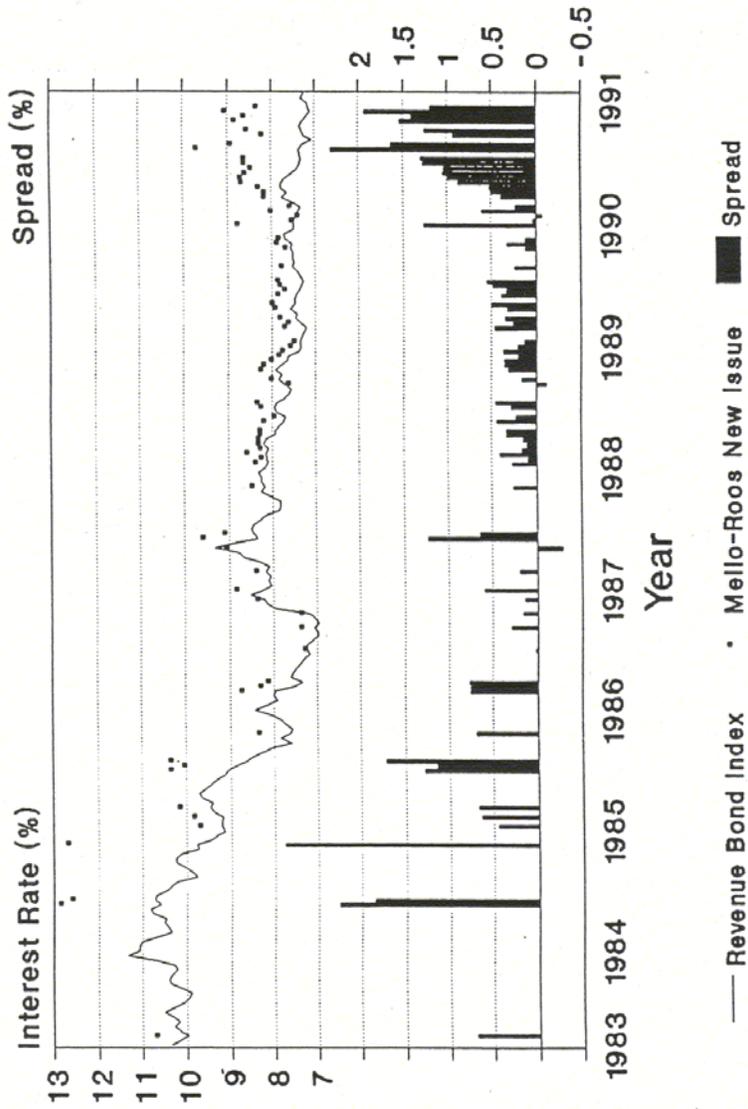
Relatively few Mello-Roos special tax bonds were issued during the first few years of the Act and the interest rate spread exhibited no clear pattern, reflecting an uncertain market response to the introduction of a new product. Beginning in 1988, the interest rate spread stabilized, averaging roughly a 40 basis points difference over an 18-month period. The warm reception which greeted new Mello-Roos special tax bond issuances at that time paralleled the state's real estate boom. As the real estate market began to sour in the second half of 1990, the spread began to rise. During the first half of 1991, many new Mello-Roos special tax bond issuances were trading at 100 to 200 basis points above the revenue bond index.

LOCAL DEBT MANAGEMENT CONSIDERATIONS

On the surface, local governments would appear to have little to lose from authorizing the formation of Mello-Roos districts and approving the sale of bonds. Mello-Roos financing allows public facilities in developing areas to be installed quickly and limits the financial liability for the bonds to landowners. The fact that Mello-Roos bonds carry an element of risk is not a problem, per se, as long as investors are aware of the risk and are compensated accordingly. In that respect, Mello-Roos bonds are similar to other higher risk municipal securities, such as multifamily housing bonds or industrial development bonds.

MELLO-ROOS NEW ISSUE PRICING COMPARISON

CHART 7



Source: PalneWebber Incorporated (9/18)

Unlike multifamily housing bonds and industrial development bonds, however, Mello-Roos special tax bonds represent tax-supported debt, rather than private obligations. Even though local governments bear no direct financial responsibility for Mello-Roos special tax debt, they are responsible for managing the levels of tax-supported debt within their boundaries, including the debt issued by CFDs. The debt capacity of developing areas--or established areas, for that matter--is a finite resource. Municipal debt is, after all, serviced by tax revenues which are in turn paid from the incomes of taxpayers. At some point, the debt burden can reach excessive levels and taxpayers become unwilling or unable to pay.

In the lexicon of the rating agencies, Mello-Roos special tax bonds are considered *overlapping debt*, because the debt issued by CFDs must necessarily overlap that issued by other local agencies. To the extent that an issuer's overlapping debt burden is viewed to be excessive, a downgrade could ensue--which would increase the costs of all future issuances' not just Mello-Roos special tax bonds. Even in the absence of a downgrade, prohibitive levels of overlapping debt could limit the issuer's flexibility in meeting future capital outlay needs. This loss of flexibility makes it important for each Mello-Roos special tax bond issuance to be weighed in the context of a jurisdiction's total infrastructure requirements. Of course, the fact that a jurisdiction prudently evaluates its future capital needs as part of a long-range planning effort does not guarantee that the planning and taxing decisions of overlapping agencies will be coordinated. The need to evaluate Mello-Roos special taxes in a broader context and to coordinate planning and taxation decisions of jurisdictions with overlapping boundaries is discussed more fully in Chapter V.

Finally, the negative publicity surrounding default argues for maintaining strict issuance and underwriting standards for individual Mello-Roos bond issuances, apart from concerns over overlapping debt levels. For all of these reasons, local governments need to exercise caution in approving Mello-Roos debt. The final chapter of this report provides guidelines for keeping Mello-Roos debt within reasonable levels and evaluating the credit quality of individual proposals.

SUMMARY

Landowner-approved Mello-Roos special tax bonds carry more risk than most municipal securities. The nature of the risk stems from the coupling of the uncertainties of the real estate development process with the strict financial requirements of municipal securities. The higher degree of risk is not itself problematic, as long as investors are compensated through higher yields. Rather, the attention of local governments should focus on keeping the levels of tax-supported debt within their boundaries to reasonable levels and evaluating Mello-Roos special tax bond issuance within a broader planning context, issues which are discussed more fully in Chapter V. In addition, local governments have an interest in ensuring the credit quality of individual Mello-Roos special tax bond issuances because of the negative publicity that would surround a default and the impact such publicity would have on their future debt issuances.

CHAPTER IV FOOTNOTES

1 Moody's Investors Service, Elk Grove Unified School District Community Facilities District No. 1, California, *Moody's Municipal Credit Report*, November 29, 1990.

2 Standard & Poor's Corp., "Shakeout in Development District's Bonds," *CreditWeek*, January 14, 1991, p. 39.

3 PaineWebber Inc., *The Mello-Roos Community Facilities Act Handbook: A Guide to Issuers and Developers*. 1990, p. 57.

CHAPTER V

GUIDELINES FOR MELLO-ROOS FINANCING

The trend towards local responsibility for infrastructure finance in developing areas is likely to continue for the foreseeable future. Persistent budget deficits will inhibit new funding initiatives from the federal government, despite widespread concern over the condition of the nation's infrastructure. At the state level, concern is growing over the amount of state general obligation bonds authorized in recent years. As a result, the state Department Of Finance's *1991 Capital Outlay and Infrastructure Report* calls for the complete disengagement of state government from school facility finance in conjunction with a constitutional amendment permitting simple majority approval for local general obligation bonds. The Legislature is also considering bills which would place on the ballot the question of majority voter approval for both local general obligation and Mello-Roos special tax bonds. In addition to governmental factors, developers are facing a credit crunch as private lenders withdraw from development loans. All of these factors point towards a continuing demand for Mello-Roos financing.

The use of Mello-Roos financing, however, should be guided by sound planning and project evaluation guidelines that go beyond the minimum requirements of state law. Accordingly, this report concludes by suggesting guidelines for local governments to consider as a framework for developing policies on the use of Mello-Roos financing. The **planning guidelines** apply to cities and counties and focus on the need to integrate decisions concerning the use of Mello-Roos financing into the land use regulatory framework. The **project evaluation guidelines** apply to all issuers and focus on (1) minimizing credit risk, and (2) maintaining reasonable and equitable tax burdens. The policy objectives of these guidelines are briefly described below.

Integrating Mello-Roos Financing Into the Land Use Regulatory Framework. From a planning perspective, Mello-Roos financing is attractive in that it can be used to avoid two common pitfalls of the development process: the unintended congestion of existing facilities and the necessity for subsidies from existing residents. Because of the landowner vote, Mello-Roos financing allows public facilities to be installed concurrently with development. The flexibility permitted in the design of CFD boundaries allows the public costs of development to be isolated on the developing area. And the tax-exempt interest rate may permit facilities to be constructed more cheaply than if the developer had arranged private financing.

However, the planning advantages cited above apply to *individual* local government units addressing the infrastructure demands of growth. Mello-Roos financing also exposes an organizational weakness in the *collective response* of local governments serving developing areas; namely that there is often no coordination of the financial decisions of different local governments supported by the same group of taxpayers. In the absence of coordinated planning,

taxpayers are vulnerable to onerous overlapping tax burdens. This is especially problematic given the ease with which CFDs can be formed. Developing areas are typically served by the city or county government, one or more school districts, and often one or more special districts. Each of these local government units has the authority to approve the formation of CFDs and to levy special taxes on the same group of taxpayers.

Though each special tax may be imposed in good faith and dedicated to worthwhile projects, the cumulative burden of the special taxes might prove excessive to the taxpayers. And though the burden of overlapping tax rates may eventually exceed the taxpayers' ability to pay, the immediate risk is probably more political than financial in nature. Angry taxpayers might lash out in some unpredictable way that could further restrict the flexibility of local officials in managing their financial affairs.

An appealing response to the problem of overlapping tax rates is the imposition of voluntary or mandatory limitations on the total amount of taxes--including Mello-Roos special taxes--which may be levied on developing areas. In fact, we recommend in the project evaluation guidelines to follow that the total tax burden in developing areas not exceed two percent of the appraised fair market value of the property upon completion of all public and private improvements. It should be recognized, however, that such limitations can produce an unhealthy competition between local governments for available debt capacity, as each local government may be tempted to grab some of the debt capacity while it is still available. Cities and counties, who control the land use entitlement process, will have a leg up in this competition. The danger is that available debt capacity will be squandered on lower priority facilities which can be phased-in later, leaving the developing area without the resources to address immediate needs.

In certain respects, the problem of overlapping tax rates in developing areas is analogous to the pre-Proposition 13 system of property taxation discussed in Chapter 1, in which each local government levied its own property tax rate. When Proposition 13 limited the countywide rate to one percent in 1978, a mechanism was needed to allocate the new, lower rate among the local government units which previously had set their own rates. The Legislature addressed this issue by enacting clean-up legislation (SB 154 in 1978 and AB 8 in 1979) to allocate the one percent countywide rate according to the proportionate share of total property tax revenues collected by each local government in the three years prior to Proposition 13. Since that time, the AB 8 property tax allocation formula has been a source of irritation to many local governments that feel wronged by an arbitrary formula that does not account for programmatic responsibilities.

To the extent that local governments voluntarily limit the tax burden in developing areas today, they do so without a formula for allocating the limited debt or tax capacity among the local governments in the service area. The absence of such a formula is desirable from a planning perspective, in that the facility and service needs for development projects will vary on a case-by-case basis. For example, some development projects might require that an expensive drainage problem be corrected before development can proceed. In other cases, school overcrowding might be the major impediment to development. In still other cases, the local government may have redevelopment funds or other revenue sources that can be dedicated to economic development purposes or other policy objectives deemed to be in the community's interest. Even in cases where Mello-Roos special tax bond financing appears to be the appropriate option, specific proposals might not withstand the scrutiny of the project evaluation criteria adopted by the local government.

Because of the disparate fiscal impacts of individual development projects, there is really no reasonable basis for making a determination ahead of time as to how available debt capacity should be allocated among local governments. However, the debt capacity is finite and should be viewed as a shared resource by all of the local governments serving the development area. Consequently, the process of balancing the funding requirements of *all* governmental entities should be an important part of land use approval decisions. To the extent that land use decisions are made without appreciation of the comprehensive fiscal impacts, the developing areas may have to live with (1) excessive overlapping tax burdens or (2) inadequate service levels.

The planning guidelines to follow suggest specific policies for integrating Mello-Roos financing decisions into the land use regulatory framework.

Minimizing Credit Risk. A key objective of the project evaluation guidelines is to minimize the credit risks associated with Mello-Roos special tax bonds. As discussed in Chapter IV, Mello-Roos special tax bond financing, along with other land-backed securities, introduces an element of speculative credit risk to the practice of local government finance. If construction and sales do not proceed as planned, the landowner may face difficulties in meeting scheduled debt service payments. The landowner vote, while desirable from a *concurrency* or timing perspective, does not offer the security of a conventional vote. It is not an expression of the community's ability and willingness to pay off the debt. As a practical matter, the landowner vote can be considered as a procedural mechanism by which local governments extend tax-exempt borrowing authority to developers. The expression of community support does not occur until people purchase the developed parcels and assume responsibility for the tax liens on the property.

Local governments need to be concerned about the credit quality of bonds issued by CFDs within their boundaries. Though financial liability for the bonds is limited to landowners, the negative publicity surrounding a default could affect the price that investors would be willing to pay for future bond issuances of the local government, as well as the prices at which its outstanding debt obligations trade on the secondary market.

Maintaining Reasonable and Equitable Tax Burdens. The objective of maintaining reasonable tax burdens in CFDs is best advanced by integrating financing decisions into the land use regulatory process, as described above. In addition, individual proposals for Mello-Roos financing will need to be evaluated to determine the tax burden that would result to residents of the CFD. The project evaluation guidelines provide objective criteria for making this determination.

Another important objective of the project evaluation guidelines is to promote an equitable distribution of the tax burden within CFDs. The project evaluation guidelines provide specific recommendations for developing equitable special tax apportionment formulas, while recognizing the need for flexibility under certain conditions.

PLANNING GUIDELINES

All development--residential, commercial and industrial--creates a burden on the community infrastructure. All development proposals must navigate a myriad of government regulations which are intended to minimize the adverse environmental impacts of development and to advance a variety of public policy objectives. Our concerns are limited to the interaction between the land use entitlement process and public finance. The guidelines below suggest that decisions concerning Mello-Roos special tax bond financing should be guided by the notion that the available debt capacity is a shared resource among the local governments serving developing areas.

Establish Financing Policies in the General Plan

Cities and counties should establish comprehensive financing policies in their general plans to mitigate the service level impacts of growth, including the impact on schools.

The general plan of the city or county should outline the community's approach towards the financing of infrastructure for existing areas and new development. In most cases, the benefit principle will serve as the operative model: existing residents will pay for infrastructure that benefits existing areas, and new residents will pay for the infrastructure required in developing areas. The entire community will pay for infrastructure that benefits the entire community. Within those broad categories, costs can be further allocated in proportion to the service demand generated by different land uses.

The financing policies should also establish that it is the intention of the city or county to mitigate the service impacts of development: development approval will be subject to adequate service capacity. The most difficult aspect to the implementation of such a mitigation policy, however, is defining the scope of a community's service *capacity*. Should the general plan of the city or county address the service capacities of the other local government units serving development projects, most significantly school districts? In our view, a comprehensive policy toward mitigating the service impacts of growth is the best way to foster cooperation in allocating available debt capacity. Establishing a comprehensive policy legitimizes the funding requirements of all governmental units serving the development project. While the public costs of individual development projects will vary on a case-by-case basis, there is a greater chance of allocating available debt capacity on a priority basis if the total costs are recognized early in the land use entitlement process. Conversely, it becomes unlikely that available debt capacity will be allocated on a priority basis when local financial planners ignore substantial capital expenditure requirements because they are the responsibility of other agencies.

In addition, the *Mira* and *Hart* decisions offer a compelling case for addressing school capacity issues in the general plan. As a result of these decisions, cities and counties that continue to maintain that the 1986 School Facilities Act preempts their authority to address school capacity issues in their planning documents are vulnerable to legal challenge. By establishing the policy that development approval is subject to adequate school capacity, cities and counties are forced to recognize the full fiscal impact of their land use decisions.

Identify Service Standards in the General Plan

Cities and counties should include level of service (LOS) standards in their general plans for individual program areas.

After establishing the policies outlined above, the next step is to adopt level of service (LOS) standards for the individual program areas, as discussed in Chapter III. LOS standards permit local planners to estimate the service impact of development projects and to demonstrate that any fees or exactions imposed meet the nexus requirements specified in AB 1600.

The operative standards for school facilities should be the cost and area standards promulgated by the State Allocation Board (SAB). Before the city or county adopts a policy of mitigating the school capacity impacts of growth, the school district itself should adopt a facility master plan consistent with the local general plan and the SAB facility standards. A mutual agreement on the SAB standards can help to avoid arguments over the *gold plating* of school facilities which sometimes plague intergovernmental relations. Placing the standards in the general plan demonstrates the commitment to mitigating the service impacts of growth according to specified criteria.

Distribute Costs on a Project-by-Project Basis

Cities and counties should distribute growth-induced infrastructure costs on a project-by-project basis.

The financing policies establish the community's general approach towards who will pay for public facilities in developing areas, and the LOS standards provide the basis for measuring the service level impact of development proposals. But the public costs of individual development projects must ultimately be distributed on a project-by-project basis.

Though we cannot offer a definitive approach to the question of when Mello-Roos financing should be used, it is possible to outline an approach toward developing the financing plan for individual development projects which follows from the discussion above. Once again, the infrastructure costs of development will vary on a case-by-case basis. For some projects, a generic application of developer exactions and/or Mello-Roos financing will generate sufficient revenues. In other cases, the infrastructure costs will exceed the normal parameters. However, if one accepts the premise that LOS standards should be maintained in the face of development pressures and that debt capacity is a finite resource, that leaves only two sources available for addressing any *residual* costs of growth: the developers themselves and the broader community.

Whether such costs are distributed narrowly or broadly will depend upon the community's application of the financing policies adopted in its general plan to the situation at hand. For some types of facilities, the community will decide that the needed infrastructure will not produce communitywide benefits and, therefore, the costs should be isolated on the development. Though development fees are limited by local ordinances and state statutes, additional fees can be imposed when individual development decisions result in unmitigated

service impacts. Under authority of CEQA, unmitigated service level impacts can be identified as *adverse environmental effects* in the draft or final EIR which must be avoided (by denying or redesigning the project) or mitigated (through the payment of a fee). As noted previously, the *Mira* and *Hart* decisions open the way for cities and counties to impose school impact fees above those authorized under the 1986 School Facilities Act.

The feasibility of broader community participation in financing capital improvements is limited by the two-thirds approval requirement for local general obligation bonds. If a simple majority approval requirement for local general obligation bonds is ultimately approved on the statewide ballot, funding decisions for facilities of communitywide benefit would likely be put to referendum more frequently. Paradoxically, school facilities--which are the subject of such controversy in the area of developer fees--might prove to be the most likely candidate for local general obligation bond financing because of the unique nature of educational benefits (as discussed in Chapter III).

Relying more on local general obligation bonds to address the school capacity demands of growth would represent a policy compromise between state funding (which may be equitable but has proven to be impractical) and entirely localized funding through developer fee and landowner-approved Mello-Roos financing (which is practical, but may be inequitable). To the extent that a simple majority voter approval requirement for local general obligation bonds would result in broader participation by the general community in financing school facilities, more debt capacity in developing areas would be freed up for other purposes. Realistically, local general obligation bond proposals would probably fare better with the voters in cases where growth is diffused throughout the school district, as opposed to cases where the demand is caused by one or two large scale development projects.

Under the acquisition-based assessment practices instituted by Proposition 13, however, the expanded use of local general obligation bond financing would place a disproportionate share of the tax burden on more recent homebuyers, by any objective measure of tax equity. A more equitable distribution of the tax burden might result from a simple majority voter approval requirement for Mello-Roos special tax bonds, which is also being considered by the Legislature. Insofar as the Mello-Roos Act does not specify how the special tax should be apportioned, the matter of equity would be left to the discretion of the local agency forming the CFD.

A simple majority approval requirement for Mello-Roos special tax bonds would permit public facilities to be phased-in more easily in developing areas after a certain amount of development has occurred. Whether the costs of those facilities would be distributed narrowly or broadly would, of course, depend upon the boundaries of the CFD. In the example of the Elk Grove Unified School District, the CFD was designed to be co-terminus with the school district's boundaries, which resulted in a broader distribution costs than if the CFD had been isolated on developing areas only. But a simple majority approval for Mello-Roos special tax bonds would not necessarily result in the broader distribution of tax burdens.

In the present fiscal environment, however, local governments may face development pressures to relax LOS standards or to overextend the debt capacity of developing areas. To help avoid such problems, the following section offers guidelines for evaluating proposals for Mello-Roos financing.

PROJECT EVALUATION GUIDELINES

The project evaluation guidelines outline both a procedural approach toward evaluating requests for Mello-Roos financing and criteria for evaluating individual proposals. The guidelines are based upon our research conducted in preparation of this report, which includes a review of several Mello-Roos policies adopted by local governments throughout the state. Some of the individual policies we reviewed contained more restrictive guidelines than are recommended here. On the other hand, we are aware that many local governments throughout the state have not adopted any guidelines. Consequently, we attempted to take a *middle ground* approach which would be of value to those communities with well-established project evaluation policies as well as to those areas which may be considering policies for the first time.

Establish a Project Review Committee

Local agencies should establish project review teams to scrutinize and assess developer applications for new Mello-Roos CFDs.

Cities and counties should establish a Project Review Committee to review developers' applications for permission to use tax-exempt bond financing for development projects (the necessity for school districts and special districts to establish such committees will depend upon the degree to which such requests are received by these districts). Membership in this Review Committee should be determined by the local governing board, depending on the experience and willingness of available staff, but likely candidates should include representatives from the Public Works Department, the Planning Department, the Assessor's Office, the Auditor/Controller's Office or Finance Department, the County Administrator or City Manager's Office, the City Attorney or County Counsel, and the Treasurer-Tax Collector.

The Review Committee should conduct an independent review of each public financing proposal according to the criteria outlined below. In addition, the Review Committee should select all of the professionals necessary to conduct the transaction (bond counsel, underwriter, financial advisor, appraiser, special tax consultant or assessment engineer, and absorption study consultant). The committee should consider requests from the applicant regarding the selection of professionals, but the consent of the applicant should not be required.

Due to the degree of risk associated with Mello-Roos special tax bond financings, the selection of competent, ethical professionals is imperative. The credit risk associated with individual Mello-Roos financing proposals cannot necessarily be ascertained in a *cookbook* fashion, the guidelines listed below notwithstanding. The judgment of experienced professionals will be needed to assess the risk of individual proposals and to develop appropriate responses.

Value-to-Debt Ratio

Local agencies should require that land within a CFD have a value-to-debt ratio of at least 3:1.

The ultimate security for Mello-Roos special tax and special assessment improvement bonds is the value of the land itself, including the value of existing improvements and any improvements to be financed through the bond issuance. In the event of a default, foreclosure proceedings will commence and the property will eventually be sold to pay off the outstanding delinquent tax lien. The ratio between the value of the land and improvements to the amount of outstanding debt on the property is called the value-to-debt ratio (this ratio is also referred to as the *value-/o-lien* ratio). To protect credit quality, local governments should require a minimum value-to-debt ratio of 3:1. The valuation should be based on a bulk sale evaluation conducted by an MAI appraiser. The bulk sale evaluation assumes the immediate sale of all properties under common ownership, which would be the situation under judicial foreclosure proceedings. The debt total should include any prior or pending special tax or improvement liens.

Special Tax Limitation

Local governments should set maximum special tax rates for landowner-approved financings at one percent (1%).

Establishing tax rate limitations can be an exercise in wishful thinking. People want low taxes and high service levels. At the heart of the debate over taxes is a trade-offs between public and private consumption. In a democratic society, those trade-off are decided through the political processes described in Chapter III. Yet, decisions to use landowner-approved Mello-Roos financing represent something of a twist on the traditional mechanisms of public choice, as local officials must decide questions of tax and spending policy for developing areas without the input of the ultimate residents of those areas. Given the degree of risk associated with such decisions, it would seem prudent not to overburden developing areas with landowner-approved Mello-Roos special taxes. At some point, the tax burden may affect the marketability of the properties, which could, in turn, cause problems for investors, landowners and local governments alike. If the buyers of properties in these development projects move in and decide to tax themselves at higher rates, so be it.

Consequently, the maximum special tax rate for landowner-approved financings should not exceed one percent (1%) of the anticipated fair market value, or assessed value, of each improved parcel upon completion of all public and private improvements. The special tax should not cause the total tax burden on residential property to exceed two percent (2%) of the anticipated fair market value of each improved parcel upon the completion of all public and private improvements. The total tax burden calculation should include projected ad valorem taxes and any overlapping assessments and special taxes.

Special Tax Inflatons

Local governments should limit annual increases in the maximum special tax to two percent (2%).

Special tax formulas should also promote stable and predictable tax liabilities, particularly for residential properties. Fluctuating special tax rates make it difficult for homeowners to plan their finances. Special tax formulas should limit escalator rates allowing annual tax increases in the maximum special tax to two percent (2%) annually.

In the event that special tax payments are supporting the provision of services, rather than capital expenditures, ongoing costs will be affected by the rate of inflation. Consequently, a higher inflator, such as the state and local deflator for goods and services, is appropriate.

Special Tax Coverage

Local agencies should set the maximum special tax at a minimum of 110 percent of expected annual debt service.

To provide added security to the bonds, the maximum special tax should generate at least 110 percent of projected annual gross debt service on the bonds. The actual coverage required will depend on the number of landowners and their financial strength. The exact coverage should be determined through consultation with the professionals working on the transaction.

Capitalized Interest Account

Local agencies should establish capitalized interest accounts if it will improve the credit quality of the bonds and result in lower borrowing costs.

Decisions to capitalize up to two years of interest into the bond issuance should be made on a case-by-case basis. The decision rule should be that a capitalized interest account will improve the credit quality of the special tax bonds and result in lower borrowing costs, benefiting all taxpayers in the CFD. From a negotiating perspective, local government should recognize that the capitalized interest account provides a source of subsidy to developers because the debt service being covered by such an account in the early stages of construction would otherwise be the responsibility of the developer.

Tax Rates on Developed and Undeveloped Land

Local government should tax developed and undeveloped land at the same rates.

The special tax formulas should promote an equitable distribution of the tax burden between developed and undeveloped land. The practice of taxing undeveloped land at lower rates than developed land can transfer some of the business risk associated with the development process from developers to home buyers. To the extent that properties are not developed as quickly as anticipated at the time of bond issuance, more of the tax burden may be shifted to the

early home buyers in the development project. Moreover, the existence of a differential between developed and undeveloped land special tax rates may not provide developers with an adequate financial incentive to form improvement areas and phase-in the construction of public facilities when possible. It does not seem equitable to require early home buyers in a development project to subsidize the construction of public facilities from which they will derive no real benefit. If local officials believe such a subsidy to be necessary, it may be more appropriate to pay for it through a broader-based tax than a special tax levied on developed property within a CFD.

As a general policy, developed and undeveloped land should be taxed at the same rates. The special tax rates should correspond to the adopted land use designations for each parcel. Undeveloped land should be taxed at rates equivalent to tax rates levied on developed properties of the same land use designation. As discussed in Chapter III, there may be a justification for taxing developed land at higher rates to pay for the early installation of large infrastructure items, such as water supply systems and sewage treatment plants that must be installed with significant excess capacity because of the economics of scale in construction. Local officials may surmise that it is equitable to charge early residents more for the immediate availability of service.

While the practice of taxing undeveloped land at lower rates may improve the credit quality of the special tax bonds in some cases, it should be recognized that the Mello-Roos Act provides other security features which, in effect, already provide a subsidy to the owners of undeveloped land. In addition, local officials have the option of requiring credit enhancements to secure the special tax payments from large property owners.

Disclosure of Special Tax Lien

New home buyers within CFD's should be provided information regarding how special tax rates are set.

In addition to disclosing the annual amount of the maximum special tax, as required by law, basic information concerning the special tax formula should be disclosed to the homebuyer. Specifically, the homebuyer should be made aware of whether or not the special tax will be levied at the same rates for developed and undeveloped properties. The local government approving formation of the CFD may wish to develop its own form for this purpose, to be signed by the homebuyer prior to the close of escrow.

Bond Reserve Fund

Local governments should set the bond reserve fund at 10 percent of the principal amount of the bonds or the maximum allowed by law.

In the event that any portion of the special tax becomes delinquent, it will be necessary to draw from a reserve fund established from proceeds of the bond sale. The reserve fund should be set at 10 percent of the principal amount of the bonds or the maximum allowed by law. (A lower reserve fund of 5 percent is appropriate for localities participating in the *Teeter Plan*, under which the county assumes the responsibility for tax payments in return for all interest and penalties on delinquent payments.) Again, the exact amount should be determined in consultation with the professionals working on the transaction.

Treatment of Delinquencies

Local governments should adopt foreclosure covenants which provide maximum flexibility.

In developing a policy on the treatment of delinquencies, local officials again must balance the objectives of tax equity and credit quality. As mentioned in Chapter III, many special tax formulas allow delinquencies to be added into the revenue requirement for the subsequent year, raising the tax burden for taxpayers who pay their special taxes on time. When the delinquencies are finally paid in full, with penalty, the revenue requirement for the following year is lowered, thereby lowering the special tax rates for all taxpayers--even those that were delinquent. The amount by which the special tax rates are reduced once delinquencies are paid in full may not be sufficient to compensate nondelinquent taxpayers for the *time-value* of the money they had to put up to cover the delinquencies.

The most equitable response to this problem would be to vigorously pursue foreclosure proceedings on all delinquencies and to draw on the reserve fund to make up any deficiencies. Therefore, special tax rates would not have to be raised for current taxpayers in order to cover delinquencies, unless the balance in the reserve fund was insufficient. Adopting such a policy, however, could create credit problems, in so far as investors view the ability to raise special tax rates (up to the maximum permitted rate), *before* tapping the reserve fund, to be an important credit feature of Mello-Roos special tax bonds. In the future, the issuer may wish to purchase bond insurance or request a credit rating once the development project becomes partially built out, to save on interest costs. Restrictive foreclosure covenants in the bond documents may preclude the issuer from this course of action.

Moreover, foreclosing special tax liens on *widows and orphans* may create public relations problems that far outweigh the benefits of a strict foreclosure policy. More specifically, if a residential property delinquency of small dollar amount and short duration does not materially affect the credit quality of the bonds, why immediately pursue foreclosure?

A good middle ground is to develop a foreclosure covenant which takes into account (1) the amount of the delinquency; (2) the duration of the delinquency; and (3) the condition of the reserve fund. The specific details of the covenant will depend upon the size and duration of the bond issue along with the concentration of the special tax base at the time of bond issuance. The purpose of the policy is to foreclose when necessary to protect the credit quality of the bonds and to be flexible otherwise.

Finally, another practice which can help to avoid tax rate fluctuations on residential properties is to specify that the interest earnings from the bond reserve fund be used to cover delinquencies. This reduces the need to both raise special tax rates to cover delinquencies and initiate foreclosure proceedings.

SUMMARY

The Mello-Roos Act provides local governments with a powerful financing tool which allows public facilities to be installed concurrently with development, while isolating the costs of doing so on the developing area. But local governments need to exercise caution in their use of Mello-Roos financing, as land-backed securities are inherently risky and may pose an excessive burden on taxpayers when coupled with other taxes and assessments. These guidelines are intended to assist local officials in taking advantage of the benefits of Mello-Roos financing while minimizing the associated risks. The planning guidelines outlined in this chapter apply to cities and counties and suggest how decisions concerning Mello-Roos financing can be integrated into the land use entitlement process. Specifically, those guidelines recommend that cities and counties establish financing policies and identify service standards in their general plans. The policies and standards should be comprehensive, covering all of the local governments units serving the development area, including school districts. These guidelines should also discuss an approach to distributing the infrastructure costs of individual development proposals among the various financing options available.

These guidelines recommend that all local governments adopt policies specifying the conditions under which they will extend the option of Mello-Roos special tax financing to developers. The project evaluation guidelines outlined above provide a reasonable framework for developing local policies. The goal of the project evaluation guidelines is to minimize credit risk and to protect taxpayers from excessive or inequitable tax burdens. Because of the inherent risk of landbacked securities, the only way to effectively preclude such risk would be to not issue landowner-approved special tax bonds at all. But the usefulness of Mello-Roos financing in addressing planning objectives makes it an attractive option, if the risks can be kept within reason.

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