Special Financing Districts

PRIMER

INTRODUCTION TO SPECIAL FINANCING DISTRICTS

Special financing districts are used by municipalities across the country to fund a wide variety of infrastructure improvements and public facilities in order to meet the demands of both commercial and residential real estate projects. This primer looks at special assessment and special taxing districts as a funding mechanism for economic development projects.

AUTHORITY FOR SPECIAL FINANCING DISTRICTS

Special assessment or special taxing districts are governed by state statutes and local law. These districts are often formed through a petition process and depending on the enabling state law, various infrastructure improvements can be funded through these districts ranging from utility improvements and roadways to schools and other civic buildings. Special taxing districts are typically a separate legal entity and political subdivision with the power to enter into contracts, own property, issue debt, levy taxes, and adopt by-laws, rules, and regulations. Districts are governed by a district board that may include the governing members of the municipality and/or individuals appointed to serve on the board. Special assessment districts have similar legal powers and may be organized as components of a larger local government or as a separate legal entity. Funding derives from a special assessment—not a tax sized to approximate the relative value of the "special benefit" that a property owner receives from district improvements and consider the relative benefit received among and between property owners. Some state statutes allow a special district to impose both an assessment as well as a tax levy. State statutes also dictate the process for formation of these districts to ensure property owners within a district have the right to object to formation of the district and/or vote on the assessment or taxes imposed. Each state has a different name for such districts like Mello-Roos in California, Community Facilities Districts (CFDs) and Improvement Districts (IDs) in Arizona, Community Development Districts (CDDs) in Florida, or Public Improvement Districts (PIDs) in Texas.

Close coordination with the local government's legal counsel is critical as statutory authorizations and district formation processes vary across the 50 states. Moreover, with special assessments, an assessment that exceeds the value of the special benefit received may be subject to litigation by district property owners.

USE OF SPECIAL FINANCING DISTRICTS IN ECONOMIC DEVELOPMENT

Special financing districts can advance economic development goals in a particular area and be used as a financing tool for private development. Developers can petition the municipality to create a district, and with the taxing authority of the district, the district can issue tax-exempt bonds to fund up-front infrastructure improvements needed for a development. The district then imposes assessments and/or levies taxes on properties within the district to repay the bonds. In effect, it encourages and possibly accelerates development, as required up-front infrastructure funding is less reliant on developer funding, and tax-exempt financing provides a lower cost of capital, thus saving money. In return, the developer should be able to reduce the cost of homes and other properties or create added amenities for the development. Municipalities also benefit from the increase in property values and the advancement of infrastructure projects, thereby promoting economic development goals.

Over the years, the number of special assessment and taxing districts has grown and municipalities have issued billions of dollars in district bonds to finance infrastructure for new development. Although there are advantages to using these districts in economic development, there are also potential draw backs and risks. At the extreme, if left unchecked, the governance structure may lead to abuse where residents are assessed or taxed for private developer gains. Even with good governance in place, municipalities have to contend with residents within a district having to paying an assessment or tax levy that residents outside the district do not have to pay. If there are multiple districts created in close proximity with varying assessments and tax rates, the disparity can create concern over time among residents. As properties change hands, property owners' understanding of the purpose behind an assessment or special tax may also lessen over time. In addition, the overlapping tax burden on residents within a district may create challenges for municipalities considering future bond elections, as residents in special districts may not be in favor of additional taxes with a special levy or assessment they are already paying.

With special taxing districts, state statutes may allow the district flexibility in increasing the tax levy sufficient to pay debt service on bonds issued. However, the municipality may want to impose limitations to protect residents from an increasing financial burden. With special assessments, the assessments are often fixed with limited or no ability to be increased once imposed.

QUESTIONS THE FINANCE OFFICER SHOULD ASK ABOUT SPECIAL FINANCING DISTRICTS

The Finance Officer should ensure the local government has a sound policy on creating a special financing district and be familiar with statutory requirements. Some key questions the Finance Officer should ask when considering a proposed special financing district are as follows:

- What is the experience, financial capacity, and funding commitment of the developer? What is the developer's financial plan? How much private equity versus district funding is anticipated?
- What infrastructure improvements are proposed for the district and are the municipality's Engineering and Development departments engaged early in the process?
- Do the improvements conform to the local government's general plan or capital improvement plan?
- How much debt is being proposed for the District? What type of security will be needed to issue bonds and what will the cost of such bonds be given that they may likely be non-rated, non-investment grade bonds?
- Is legal counsel, including bond counsel, engaged at all stages to avoid conflict and litigation?
- Is the municipality's governing board knowledgeable about the potential drawbacks and risks to ensure they can respond to developers requesting that the municipality create a district?
- How will the municipality be protected from financial obligations and legal exposures of the district? What happens if delinquencies increase or property values fall and tax rates are insufficient to cover debt service for bonds issued? How will the municipality be affected?
- What financial assurance will be provided? For example, a cash deposit or a letter of credit?
- What is the total estimated financial burden on property owners within the district, including the proposed tax levy or assessment, impact fees, HOA fees, utilities, and other charges?

- Should district property owners bear the cost of this development or is it more appropriately a government-wide cost?
- How will property owners within a district be protected from increasing tax levies, bond defaults, or developer defaults?
- What are the disclosures to potential home buyers to ensure proper notification and full disclosure of assessments and taxes imposed on properties within the district?
- What is the public engagement or communication plan?
- What is the overlapping tax burden on property owners within the district? Will this pose a challenge for the municipality during future bond election referenda?
- What will be the broader impact over time of multiple districts in close proximity with varying assessments and tax levies?
- How will the district pay for operating and administrative costs?

OUTSIDE RESOURCES FOR SPECIAL FINANCING DISTRICTS

- Municipal Finance Journal, Development District Bond Financings: The Good and the Bad
https://www.civicresearchinstitute.com/online/article_abstract.php?pid=4&iid=919&aid=6019
- Establishing an Economic Incentive Policy
http://www.gfoa.org/establishing-economic-development-incentive-policy
- Evaluating and Selecting Economic Development Projects
http://www.gfoa.org/evaluating-and-selecting-economic-development-projects
- CDFA Special Assessment Finance Resource Center
https://www.cdfa.net/cdfa/cdfaweb.nsf/resourcecenters/specialassessment.html
- League of Minnesota Cities, Special Assessment Toolkit Website
https://www.lmc.org/media/document/1/sagtext.pdf?inline=true
- California State Legislature: Assessing the Benefits of Benefit Assessments, 3rd Edition
https://sgf.senate.ca.gov/sites/sgf.senate.ca.gov/files/Assessing%20the%20Benefits%20of%20Benefit%20Assessments%20801-S.pdf