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Local Financing Techniques For Capital Projects

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Infrastructure facilitates economic growth, and its value to a community may be gauged by the opportunity costs that would be incurred without it. Rapid population growth in many Tennessee counties and in the state as a whole is manifesting itself in a dramatic number of planned or needed capital projects. According to TACIR's March 2002 report, *Building Tennessee's Tomorrow: Anticipating the State's Infrastructure Needs*, these needs are dominated by transportation, education, and water and wastewater. Local governments expect to fund more than half the cost of all infrastructure projects for which sufficient funds are available, but lack one-third of the funds necessary for all projects needed to be in some stage of development between 2001 and 2006.

The state restricts the means by which local governments generate revenue, and for this reason, inventive financing techniques should be explored. This report briefly identifies the public financing techniques commonly used by Tennessee local governments as well as describes more innovative techniques employed by local governments in other states.

Currently Used Resources

Local taxes.[1] City and county governments have greater control over property taxes than over other taxes. Unlike local option wheel and sales taxes, which are subject to constraints including rate limitations, spending restrictions and referenda requirements, property tax rates can be altered at the discretion of local elected officials. Nevertheless, the responsiveness of property values to overall economic growth is higher in some counties than in others. This variation in property tax elasticity means that some counties are unable to collect essential revenue without frequently changing the property tax rate.

State-shared taxes.[2] Of the 13 taxes that the state shares with local governments, eight can be spent at the discretion of local officials, but five are restricted to specific

[1] TACIR Staff Report (March 2000). *State Shared Taxes in Tennessee*. Available online [http://www.state.tn.us/tacir/PDF_FILES/Taxes/execpdf.pdf].

[2] Id.

uses. The distributions of gasoline, motor fuel, and petroleum taxes are partially or fully designated for road expenses. The mixed drink and coal severance taxes are partially or fully earmarked for education. Distribution of state-shared taxes varies widely because the criteria for allocation differ for each tax.

Grants. Limited funds are available through federal and state agencies. Grants are usually awarded on a competitive basis for special projects and are scarce for new capital projects. Although grants can be useful for construction of capital projects, they generally are not a regular source of funds for their operation and maintenance.

Loans. The Tennessee Local Development Authority provides loans to local governments for water, sewer and solid waste resource recovery facilities and other capital improvement projects.[3]

Utilities. These are sovereign public corporations that oversee the operation of public works systems and are under the jurisdiction of local governments. The Tennessee Valley Authority is practically the exclusive provider of electricity in Tennessee, but is tax-exempt because it is a federal corporate agency. Instead, TVA distributes 5% of its annual gross receipts to city and county governments as payments in lieu of taxes. Local governments have come to depend on this reliable revenue source in their budgets.[4]

Municipal bonds. Bonds are frequently used to finance capital projects because the government can pay the large initial expense of infrastructure construction and repay the bondholders as the expenses are recovered over time. The two broad categories of bonds are general obligation and revenue bonds.

- **General obligation bonds** are secured by the government's ability to tax its citizens and are frequently used to finance such projects as roads and public buildings.
  - TCA 9-21-201 addresses the process by which local governments may issue bonds and notes.
  - School bonds are discussed specifically in TCA Title 49, Chapter 3.
  - A recent example is the financing of the Nashville Arena. The city of Nashville increased residents' property taxes to secure $120 million in general obligation bonds for its construction.[5]
- **Revenue bonds** are used to finance projects such as water or wastewater facilities and are secured solely by expected fees that are collected from users of the facility or service. (Refer to TCA 9-21-301 for further information.)

Notes.[6] While bonds are useful for long-term financing, it may be necessary or desirable to use short-term financing tools such as notes. Local governments may pass

[3] More information is available on the Tennessee Local Development Authority, Division of Bond Finance, Tennessee Comptroller of the Treasury, web site [http://www.comptroller.state.tn.us/bf/bftlda.htm].

[4] TACIR Technical Report (October 2001). *Potential Impacts of Electric Utility Restructuring on Local Governments in Tennessee*. Available online [http://www.state.tn.us/tacir/PDF_FILES/Other_Issues/ElectUtilDeregReport.pdf].

[5] Barnert, Ben (April 1997). *In Tune With Music City* [online]. Panstadia, Vol. 4, No. 2. [http://www.panstadia.com/vol4/42-006.htm].

[6] Division of Local Finance (last updated July 19, 2001). *Guide for the Issuance of Notes* [online]. Division of Local Finance, Tennessee Comptroller of the Treasury. [http://www.comptroller.state.tn.us/lf/guidform.htm].

resolutions to issue notes for approved uses, but the State Director of Local Finance in the Office of the Comptroller of the Treasury must approve the resolution before it can be executed. Restrictions on the amount, maturity, and sale of notes are detailed in TCA Title 9, Chapter 21.

- **Bond anticipation notes** may be issued to finance eligible capital projects, pending a bond issue.
- **Capital outlay notes** may be issued for three-, seven-, or twelve- year maturities, depending on the project involved.
- **Tax anticipation notes** are secured by future tax revenues, and must be redeemed by the end of the fiscal year.
- **Grant anticipation notes** may be used if a local government has a contracted grant from another government agency that meets or exceeds the face value of the notes (TCA 9-21-701).

Impact fees.[7] As of the end of calendar year 2001, twelve counties and eighty-five municipalities in Tennessee, (97 total) had been granted authority by the state legislature to levy impact fees and development taxes either by public or private acts or in their municipal charters. Of these 97 local governments, eleven counties and fifteen municipalities (26 total) have passed ordinances implementing that authority, and one county and seventy municipalities (71 total) have not. As the purpose of the fees is to recoup growth-related expenses from new residents, they may be unpopular with realtors and large, local employers.

Innovative Financing Techniques

While the methods listed above have validity in many situations, local governments may find it useful to explore more innovative financing strategies. Several approaches have been used by local governments in other states or have been tried in Tennessee, but are not widely used. These examples should be considered in the context of public policy concerns, such as equity and market elasticity, and administrative concerns, such as cost allocation and timing.

- **Special assessment districts**[8] (SADs) are areas in which additional fees or taxes are levied to finance a specific project. Costs of improvements are allocated to those who benefit from them, which encourages self-directed development. Administration of SADs can be complicated. They are frequently used to support bond issues and are fairly widely used. Here are some examples:

  - **Transportation**

    Texas has used special road districts extensively to allow local governments to finance new road construction and then transfer the roads to the state for maintenance. Two types of districts, which differ in creation process and administration, are allowed, but both are funded by ad valorem taxes.

  - **High Growth Areas**

    Pleasanton, **California**, is a suburb of San Francisco, and used SADs in the 1980's to finance infrastructure needs caused by rapid growth. City officials determined that the tax

[7] TACIR Staff Research Brief No. 9 (April 2002). *Paying For Growth: General Assembly Authorizations For Development Taxes And Impact Fees*. Available online [http://www.state.tn.us/tacir/PDF_FILES/Growth_Policy/PayingForGrowth.pdf.]

[8] National League of Cities (December 1987). *Financing Infrastructure: Innovations at the Local Level*. Prepared by Apogee Research, Inc. Washington, DC: National League of Cities.

burden should be related to the proximity of the property to the infrastructure location and that property owners could pay in a lump sum or in annual installments. Assessments ranged from $13,000 to $50,000 per acre. The risk associated with such an arrangement is that growth will not materialize or that property owners will not be able to afford the taxes.

- **Rural Areas**

  Missoula County, **Montana**, uses rural special improvement districts (RSIDs) to finance new capital improvement and capital maintenance. Neighborhood RSIDs are intended for residential area improvement, while developer RSIDs are undertaken to improve commercial land to a marketable state. This system has proven successful for an area with relatively low population density.

- **Voluntary Special Improvement Districts**

  In Fort Collins, **Colorado**, landowners within an area may petition to create a voluntary special improvement district. Residents who do not wish to participate are not required to, even if they will benefit from the project, but may later be persuaded to contribute. In addition to this unique, noncompulsory system, the local government is empowered to establish involuntary SIDs where it sees fit.

♦ **Tax increment financing (TIF) districts**[9] are areas in which tax revenue growth is designated to support a particular project. This technique is typically used to support repayment of bonds. The justification for TIF is that the project will stimulate economic growth, which will be used to recapture the city's investment. This rationale suggests that it is most appropriate for cities with sluggish growth. Often the facilities supported by TIF are directly associated with private investment. Concerns to be addressed during the creation of TIF districts include the effect of inflation on the base tax revenue, the option to change tax rates, and the ability of districts to accurately attribute growth to the project. TIF supervision can also be complicated.[10]

- **Improving undeveloped land**

  In Davenport, **Iowa**, TIF was initiated to repay a state loan for highway improvements. Instead of equal loan payments, the level of revenue growth will dictate how quickly the loan is repaid. Davenport experienced prompt commercial development in the district. The city's TIF project has been quite successful, thanks to flexibility of its loan program.

- **Improving developed land**

  Orlando, **Florida**, floated $19 million in serial revenue bonds on property tax growth in a TIF district. The proceeds were used to improve infrastructure, housing, and pedestrian access. Significant commercial and residential investment in the ensuing years led property assessments to increase sharply above the base year of 1981.

[9] Id.

[10] *Tax Increment Financing: Is it an Effective Way to Finance Urban Development?* Draft, Lisa Wilson, TACIR, (August 2000).

- **Exactions**,[11] donations of land, fees, services, etc., that a government receives from a developer, can be systematic or flexible. Impact fees are a common form of exaction.

  - **Systematic exaction**

    Loveland, **Colorado**, responded to accelerated demand for services in the 1980s with a two-part development fee schedule. Hook-up fees for utilities and ongoing capital expansion fees for public services were designed to equitably distribute the costs associated with growth. Loveland occasionally compares its fees to nearby communities to avoid deterring potential development.

  - **Flexible exaction**

    Corpus Christi, **Texas**, created trust funds to pay for water and sewer systems. Developers make contributions to the funds based on characteristics of the lots developed and are reimbursed if their use is lower than anticipated. This allows for equitable distribution of the costs of infrastructure construction.

- **Public-private arrangements** involve direct interaction between the public and private sectors in a joint venture.

- **Active private participation,** in which a private company directly invests in or administers a basically public duty.

  Babylon, **New York**, issued tax-exempt bonds to finance the construction of a solid-waste disposal plant on town-owned land. This public equity was enhanced by a private operator who leased the plant. A share of the revenue the operator collects through service fees and recycled-waste sales is used to pay the debt service.

- **Passive private participation,** in which private developers contract the use of a public facility, or investors purchase a facility and lease it to the government.

  Oxnard, **California**, issued certificates of participation, a form of private equity, to purchase land for a sports facility and a hotel. Certificates function like bonds, but do not require voter approval and are backed by physical assets. The seller of the certificates, the Oxnard Public Facilities Corporation (PFC) leased the land to the city for the amount of the debt service, and the city in turn leased it to the facilities' developer. The developer's payments to Oxnard fall under the category of public equity.

- **Public equity**, when a private venture dispenses some of its revenue to a government in return for property or services.

  For the same project, but independent of the private equity arrangement above, Oxnard, **California**, also utilizes public equity. The hotel pays a minimum fee or a percentage of gross revenue, whichever is greater. The effect of this system is that the city has a financial interest in the performance of the hotel, but low sales will not prevent the city from meeting its debt service requirement. In addition, the city benefits from incidental bed and sales tax revenues.

[11] National League of Cities (December 1987).

Innovative Financing in Tennessee

Some of the methods described above are authorized and employed in Tennessee.

- **Special Assessment Districts**
  - Special school districts (SSDs) are authorized to levy additional property taxes to support a school system; however, the creation of new SSDs was prohibited in 1982 under TCA 49-2-501. Several counties have at least one SSD in their borders. Carroll and Gibson Counties have several.
  - Road improvement districts are permitted under TCA 54-125-101. The districts must be contained within county borders, and are allowed to issue bonds secured by property taxes for road construction.
- **Tax Increment Financing Districts**[12]
  - Property tax TIF is permitted under TCA 13-20-205. A notable example of its use in Nashville is the BellSouth Tower, which was financed with $13.5 million in loans that are scheduled to be repaid by 2002. Knoxville's past property tax TIF projects have failed to produce tax collections to meet its debt service requirement, and the city now includes developer guarantees in its contracts.
  - Sales tax TIF is allowed by Public Chapter 1055, which specifically addresses tourism-stimulants such as convention centers. Knoxville and Chattanooga are the only cities that have taken advantage of this form of TIF so far.
- **Certificates of Participation** have been sold by Hamilton County to support public schools.[13]
- **Investments** are encouraged by the Division of Local Finance as a means of planning for future growth. Unlike many of the tools already described, investments are a revenue source, not a method of financing individual projects. Authorized investments are listed in Tennessee Code Annotated for the following:
  - Cities—TCA 5-8-301
  - Counties—TCA 6-56-106
  - Utility districts—TCA 7-82-108

Local Finance Responsibility Across the Country

Census data indicates that an increasing share of public works expenses is shouldered at the local level relative to the state and federal levels. In fact, the period 1960 through 1984 was characterized by an increase in the proportion of local government's public works outlays from 40% to 49%.[14] If a gradual change in federalism is the reason for this trend, there is reason to believe that the shift has continued since the 1980's.[15]

The above observation does not reflect the variability across states in the budgets of cities and counties caused by different state tax structures. The fact that a particular

[12] *Tax Increment Financing: Is it an Effective Way to Finance Urban Development?* Draft, Lisa Wilson, TACIR, (August 2000).

[13] Queen, Ron (Manager, Division of Local Finance, Tennessee Comptroller of the Treasury). Interview by Danielle Gros (July 31, 2001).

[14] National League of Cities (December 1987).

[15] Loder, Ross (Research Director, Tennessee Municipal League). Interview by Danielle Gros (August 16, 2001).

state forbids local-option sales tax or limits property tax assessment may explain why that state takes greater financial responsibility for infrastructure, while a state that allows local governments more latitude does not.

Moreover, accurately determining the fiscal contributions of each level of government is complicated by the nature of local government budgets given the utilization of general funds. A general fund may contain revenue from the state and federal governments in addition to those from local sources, making it difficult to track the source of funds for a capital expenditure that is not financed by a specific tool.

Conclusion

When "free money" is not provided for local infrastructure projects by the state or federal government, cities and counties must explore alternative revenue strategies. The financing methods described above have been used by local governments around the country with varying degrees of success. Several of them are compatible with traditional financing instruments like municipal bonds. While it is useful to examine case studies, it is essential to choose carefully a financial strategy that will suit the needs of a particular city or county.

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