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Innovative Methods of Local Government Infrastructure Financing: A Guide to Comprehensive Financial Planning for Local Governments

by Paul Nicolosi

Recently articles have appeared in the Illinois Municipal Review regarding the need for increased planning related to financing municipal infrastructure.[1] These articles are an echo of the broader financial challenges faced by local governments across the country. The National League of Cities' (NLC) CityFutures Panel on Public Finance[2] recently identified and explained these financial challenges:

"Our nation's system of public finance is woefully out of date. It is time to stop hiding from the problems and the challenges we face. It is time for public discussion of the need for far-reaching changes in how we pay for essential government activities at all levels."[3]

The United States still has in place a system of public finance modeled after a 19th- and 20th-century economy.[4] In the past, financing of public infrastructure was based on property taxes collected from manufacturers with large facilities. There has since been a shift in our country from the production of goods to services, which has represented our movement to a "knowledge-based economy."[5] Furthermore, accompanying this shift is a shift in residents' needs.

Cities and counties are experiencing an overall change in needs related to increases in urbanization, population, and immigration as well as an aging society for which localities are required to provide services.[6] With the relocation of industries elsewhere, accompanied by the change in residential needs, other financing methods are necessary to provide adequately for continuity in municipal services.

Further complicating the financial issues is the decline in federal funding and block grants to state and local governments. Block grant funding was more prevalent during the 1960s and the 1970s. In the 1980s, however, grants were consolidated, resulting in 25 percent less federal funding than the grant programs they replaced.[7]

The erosion of federal funding through block grants "leaves states and localities the option of either curtailing services or increasing their own taxes to compensate for declining federal funds."8

Also, experts have noted that under the proposed 2008 budget "grants to state and local governments for all programs other than Medicaid would decline by $12.7 billion or 5.1 percent from fiscal year 2006 to 2008."[9]

With the consolidation of grants and the decline in federal funding generally, it is necessary that municipalities act proactively to seek out potential revenue sources in order to ensure a continuous flow of funding.

COMPREHENSIVE FINANCIAL PLANNING: A PLANNING TOOL FOR FUNDING LOCAL INFRASTRUCTURE

To overcome the financial issues confronting them, local governments must use innovative solutions and set systematic goals. The cornerstone of a community's desire to establish these goals and craft innovative solutions is the creation of a comprehensive financial plan (CFP).

Much like a comprehensive land use plan, a CFP serves both as a planning tool and as a defense mechanism against challenges to a community's implementation of project-specific fees.[10] Effective utilization of a CFP should strike a fair balance of development costs by apportioning off-site[11] infrastructure improvement costs between developers in a defined area and local governments.

Ideally, a CFP is created in conjunction with or as a supplement to a local government's overall comprehensive land use plan. It augments the plan and establishes a rational basis for the cooperative financing tools that communities can and must adopt to pay for required off-site infrastructure.

Simply put, it is a community's financial plan that incorporates a variety of innovative financing tools needed to pay for the uses set out in the plan. An important part of a CFP is the use of economic analysis to establish an equitable financial relationship with developers for the payment of off-site infrastructure needed to effectively carry out the comprehensive land use plan without excessively burdening the community's general real estate tax base.

Such economic analysis, coupled with the unique financing tools available to local governments, creates the optimal solution for financing off-site public improvements that are needed to manage the growth caused by new development.

Essentially, a CFP pulls together all of the financial aspects of a single development, a broader plan area with multiple developments, and even an entire community into a single comprehensive financing plan that focuses on funding off-site improvements. A quality CFP involves the coordinated effort of all three of the primary disciplines involved in economic development—legal, land planning, and finance. These disciplines must be exercised in a collaborative and unified manner to create a balanced and equitable approach to financing off-site infrastructure improvements required for a community's orderly growth.

Preparation of a CFP involves several components, and each component can be added or deleted depending on the particular needs of any given place. To ensure the optimal plan, a thorough analysis must be conducted to determine the community's needs. This analysis must look at the comprehensive land use plan, review the community's existing off-site infrastructure, and forecast the community's growth.

These are all similar determinations that are made in the community's comprehensive land use plan and are why creating the CFP in conjunction with the land use plan is optimal. From this foundation, the community can then begin to assess its infrastructure needs, the associated cost, and the funds that will likely be available to finance them. These are the basic building blocks to the plan. With them, a place can move on to considering innovative means for covering the cost of required future off-site improvements. Part of this consideration should include an understanding of how the community's neighbors cover these same costs. It is important that every community create a financing model that keeps it competitive with neighboring communities.

Beyond funding concerns, the implementation of a CFP provides numerous other benefits to the community. One of the practical but critical benefits of establishing a plan is the clear, up-front communication to developers about local financial requirements for off-site infrastructure improvements and the costs of doing business in any given community.

If a local government acts within the self-imposed limits of its CFP, legal and practical challenges to off-site development financing requirements can effectively be managed. Providing fiscal reasonableness and predictability requires a thorough CFP. Development of such a plan will require resources up front but will pay off in the long term. The rate of development and funding for any given development will be more stable when developers can predict infrastructure contributions and alternative financing mechanisms to pay for them.

Another compelling reason for a local government to establish a CFP is that by implementing one, a locality may reduce its exposure to liability caused by challenges to the various fees it charges for development. The ultimate goal is to provide economic fairness in the financing of new or upgraded infrastructure, in addition to ensuring constitutionality. By having a uniform plan with a rational and well-conceived financing approach, localities eliminate the criticism that one developer may have been treated unfairly.

CFPs can be the basis for the coordination of infrastructure financing, thereby adding efficiency, predictability, and fairness to the process of imposing financial demands on new developments. Finally, the plan will lay a legal foundation as a document that indicates a community's rationale and methodology in establishing its CFP. Legal challenges to municipal financing can be avoided and more solidly defended if all parties are aware of expectations up front by way of a published policy created in a CFP. Finally, judicial deference is paid to municipalities that properly document and outline their intentions when dealing with upcoming developments.

When considering how to pay for infrastructure, local leaders have historically had two types of taxes to consider: (1) general property taxes for general revenue and (2) "other" taxes that fund specific public works and services. Local governments usually use these other taxes to upgrade or expand infrastructure for new development.

The authority to implement these fees has been widely understood to be premised on local government's police power. An issue exists, however, as to whether these regulatory fees exceed local government's police power. This idea has been the subject of ongoing debate and litigation. The establishment of a CFP that clearly sets out the community's findings and the rational and equal implementation of these other taxes are key to defending legal quarrels.

SPECIFIC INNOVATIVE FUNDING SOURCES AVAILABLE

In Illinois, the cap on property tax increases and diminished or nonexistent state and federal infrastructure funding mean that local governments must become savvier about planning and funding their off-site infrastructure.[12] Modern and more specific infrastructure financing methods are numerous and somewhat complex. Different financing methods are better suited for different stages of development.

In developed areas where public facilities need upgrading or expansion, financing methods may include general property taxes, sales taxes, excise taxes, tax increment financing (TIF), business districts, bonds, motor fuel tax, and various types of special taxing districts. TIFs are considered an alternative revenue source and are well suited for mixed and partially developed areas.

In areas of new development, however, financing may involve special taxing districts, exactions, common exactions for basic infrastructure, impact fees, and excise taxes. Special taxing districts are one method that can be used for both existing and new area infrastructure requirements. A brief summary of some of the major financing options is necessary to better understand the complex blend embodied in the properly tailored CFP.

First, TIF is a tool used to eradicate blighted conditions and provide for the restoration and enhancement of the tax base.[13] The term "blighted" carries a complex definition depending on the type of property and the number of listed statutory characteristics met.[14] Assuming that the land qualifies as blighted and the plan is necessary for redevelopment, to implement a TIF, the local government first approves the redevelopment project by passing an ordinance. The current property taxes on the development area are frozen on the day the ordinance is passed by adding together the equalized assessed value (EAV) of all contiguous parcels within the redevelopment project area to arrive at the "total initial equalized assessed value." The portion of taxes

"attributable to the increase in the current equalized assessed valuation of each . . . parcel of real property in the redevelopment project area over and above the initial equalized assessed value of each property in the project area shall be allocated to and when collected shall be paid to the municipal treasurer who shall deposit said taxes into a special fund called the special tax allocation fund of the municipality for the purpose of paying redevelopment project costs and obligations incurred in the payment thereof."[15]

The tax increase resulting from the difference between the current EAV and the total initial EAV (the increment) ends up paying for the redevelopment costs.[16] This municipal financing strategy is intended to be used for only 23 years.[17] The TIF Act was amended recently to allow for members of the TIF corporate authority to have an interest in property within the redevelopment project area provided that certain requirements are met.[18]

Second, substantial changes took place in 2005 to the Business Districts Development and Redevelopment Act. Like TIF, business districts are intended to be used for blighted areas, where such plans are necessary for the development of the district for the enhancement of the tax base. The definition of blighted for business districts, however, does not carry the level of detail as required by the TIF Act.[19] Also like TIF, the business district areas must be contiguous and must include only parcels of real property directly and substantially benefited by the proposed business district plan.[20]

Once the business district has been established under ordinance or resolution, the corporate powers of the locality include the powers to exercise eminent domain, borrow funds, enter into contracts, and so forth.[21] Pursuant to the business district plan, the local government may impose additional retailer's occupation taxes, services occupation taxes, and hotel operator's occupation taxes. If a community chooses to impose the retailer's occupation tax or the services occupation tax, the community is also required to impose the other at the same rate.[22]

The tax rate for all three taxes individually cannot exceed 1 percent of the gross receipts from the sales made in the course of such business and must be imposed only in 0.25 percent increments.[23] Once these tax revenues are collected, they are distributed into the business district tax allocation fund from which they are used to pay for business district project costs as set forth in the business district plan approved by the community. These funds are intended to be used within 23 years after the date of adoption of the ordinance approving the business district.[24]

Third, there are two types of special taxing districts that a community can implement. The first of the two types is the special assessment (SA). The SA is used for infrastructure improvements that specifically benefit a particular area or landowner greater than that benefit received by the community as a whole. A special assessment district originates through the passage of an ordinance with the approval of the board of local improvements.[25] The creation of an SA involves a complex public hearing process that requires the oversight of experienced legal council.

After an SA has been established, bonds are usually issued to pay for the infrastructure improvements. SA costs are estimated for the portion of improvements that benefit public and private property. Total costs are then apportioned between them so that each will bear equitable proportion.[26] An important limitation to the use of SAs is the requirement that the amount assessed against property cannot exceed the benefit derived from the SA improvement.

Individual parcels within the area are then assessed based on an incremental increase in value caused by the improvements being paid for by the SA.[27] The assessments pay for the retirement of the bonds, which are paid in a number of installments depending on type of improvement. Improvements usually result from issuing bonds that are retired by payments made against the private portion from the tax collected on each property and on the public portion from any undesignated source of the governing body.

The second type of special taxing district is the special service area (SSA). In an SSA, certain infrastructure improvements or services are provided to specific areas within the governing body that benefit only those properties within the designated area. The use of SSA is flexible because funding for a greater variety of improvements is allowed with SSA compared with special assessments.

There are two options for paying for special services. Taxes may be levied by the locality in the SSA "at a rate . . . sufficient to produce revenues required to provide the special services."[28] The local government may also issue bonds for the payment of services in the area of improvement, which must be retired by the levy of additional taxes in the designated area "in amounts sufficient to pay maturing principal and interest . . . without limitation as to rate or amount.[29] Unlike an SA, an SSA tax does not require measurement of the benefit to each property within the district. Rather, apportionment of SSA cost is done according to one of three methods. If a special tax is levied, there must be a rational relationship between the amount of the tax levied and the special service benefit rendered.[30]

If an ad valorem property tax is levied, the tax must be based on the equalized assessed values of the entire area.[31] As an alternative to a property tax based on the whole EAV of the SSA, the local government may impose an ad valorem tax based on EAV of land within the SSA without regard to improvement if the EAV of land is at least 75 percent of the total of the whole EAV of the property within the SSA at the time it was established.[32]

The implementation of an SSA can be initiated either by the community or at the request of some or all of the property owners in a given area who seek particular improvements or services. The establishment of an SSA is subject to potential opposition filed against the SSA formation with 60 days of the public hearing to create it. To be considered successful, a challenge must be by both a majority of those persons who have title to the property in the SSA and a majority of the registered voters who live within the SSA. This is often a difficult hurdle for opponents to achieve.

Finally, there has been a recent statutory addition to the SSA statute to protect the health of workers, tenants, and visitors to buildings. The addition establishes SSAs for improvements to buildings if such improvements are required by ordinance. For SSA approval, owners of 100 percent of the parcels subject to the tax funding the SSA must agree with the SSA establishment. If the locality does not have all required signatures on a petition to the clerk, an SSA cannot be formed and the municipality may not retry for approval for one year.[33]

Another option for local governments to consider in the development of CFPs are exactions. An exaction can be any requirement that a developer gives something to the local government as a precondition for development approval. A typical exaction is the dedication of land or a cash requirement for park and school districts. Home rule status is not required; however, a local government must first pass an ordinance.

For new development, exactions can be imposed as part of the annexation or subdivision application process in both home rule and non–home rule communities. Nevertheless, the major disadvantage of exactions is that they do not have an up-front financing mechanism that provides developers and or municipalities the necessary cash to make the improvements in advance of receiving the fees. Thus, local governments may be unable to use this financing technique without first having sufficient cash available to pay for the improvements up front.

The community can consider the imposition of an impact fee. This fee is a one-time fee imposed by local government as a prerequisite for development. The underlying intent is to recover the costs of infrastructure capacity needed to serve new residents of the development. Impact fees allow local governments to accommodate new development without increasing taxes on existing residents. Impact fees are generally not considered a tax but an exercise of the local government's regulatory powers.

Authority to impose these fees is found pursuant to numerous powers. The first justification is the police powers for the health, safety, and welfare of the community. Communities must have home rule to impose impact fees, otherwise they can only pass what state statutes allow.[34] Finally, annexation agreements provide a justification whereby a city or county may require contributions of land or money, or both, as a condition for the annexation of the requested parcel.[35]

In addition, the Illinois Legislature is currently reviewing a proposed Development Impact Fee Authorization for Local Governments Act in the form of SB 0232, which will provide express statutory authority for the imposition of development impact fees.

RECOGNIZED NEED EXISTS FOR COMPREHENSIVE FINANCIAL PLANS

It is clear that local governments have a number of methods of financing infrastructure development and promoting economic growth within their borders. The challenge is using these tools in a comprehensive, fair, and coordinated fashion that will withstand legal challenges from unhappy developers. Local governments would benefit substantially from creating a CFP. Communities can use this instrument to define the extent of the local government's infrastructure financing from its general fund and from more specific taxes on developers who benefit more directly from the improvements.

With a CFP, all financial aspects of future development are pulled together in a single comprehensive document. Legal issues, land planning, and finance are combined to create a fair and balanced approach to infrastructure development in an effort to carry out orderly growth. Proper planning also can reduce future legal challenges to the financing demands. PM

[1]See Norman Walzer and Lori A. Sutton, "Municipal Revenue Trends: Strategies and Responses," Illinois Municipal Review (April 2007): 11.
[2]This panel comprises municipal leaders from across the nation who have been at the forefront of NLC's efforts to call attention to the challenges facing the U.S. system of public finance.
[3]"Taxing Problems: Municipalities and America's Flawed System of Public Finance" (Washington, D.C.: National League of Cities, May 2006), 1, www.nlc.org/ASSETS/EC15AAB9C3184B56A798CCD4A9169891/cityfuturestaxingproblems.pdf.
[4]Ibid.
[5]Ibid., 2.
[6]Ibid.
[7]Kenneth Finegold, Laura Wherry, and Stephanie Schardin, "Block Grants: Historical Overview and Lessons Learned," New Federalism: Issues and Opinions for States (Urban Institute), No. A-63 (2004), www.urban.org/UploadedPDF/310991_A-63.pdf.
[8]Iris J. Lav, "Federal Grants to States and Localities Cut Deeply in Fiscal Year 2008 Federal Budget" (Washington, D.C.: Center on Budget and Policy Priorities, February 6, 2007), 1, www.cbpp.org/2-6-07sfp.pdf.
[9]Ibid.
[10]For a complete discussion of these topics: See Edward J. Sullivan and Isa Lester, "The Role of the Comprehensive Plan in Infrastructure Financing," Urban Lawyer 37 no. 1 (2005), 53–85.
[11]For purposes of this article, off-site improvements are defined as that infrastructure that is needed in any given area to properly manage development but is not within any given plat. It includes such items as trunk lines, water mains, and traffic and street improvements that are not part of any particular subdivision but benefit an entire plan area, which thereby benefits more than any single developer.
[12]For more information on the Property Tax Extension Limitation Law (PTELL) see Illinois Compiled Statutes (ILCS), sec. 35, 200/18 (West 2007).
[13]ILCS, sec. 65, 5/11–74.4–2(b) (West 2007).
[14]ILCS, sec. 65, 5/11–74.4–3(a) (West 2007).
[15]ILCS, sec. 65, 5/11–74.4–8(b) (West 2007).
[16]See People ex rel. City of Canton v. Crouch, 79 Ill. 2d 356 (1980), which upheld the Tax Increment Allocation Redevelopment Act against constitutional challenge and described general TIF procedures.
[17]ILCS, sec. 65, 5/11–74.4–3(n) (West 2007).
[18]ILCS, sec. 65, 5/74–4(n) (West 2007)
[19]ILCS, sec. 65, 11–74.3-5(3) (West 2007), which found blight for "inadequate street layout, unsanitary or unsafe conditions, deterioration of site improvements, improper subdivision or obsolete platting, or the existence of conditions which endanger life or property by fire or other causes, or any combination of those factors, retards the provision of housing accommodations or constitutes an economic or social liability or a menace to the public health, safety, morals, or welfare in its present condition and use."
[20]ILCS, sec. 65, 5/11–74.3–5(2) (West 2007).
[21]ILCS, sec. 65, 5/11–74.3–3(1)–(14) (West 2007).
[22]ILCS, sec. 65, 5/11–74.3–6(c) (West 2007).

[23]ILCS, sec. 65, 5/11–74.3–6(b) (West 2007).
[24]ILCS, sec. 65, 5/11–74.3–6(a)(West 2007).
[25]ILCS, sec. 65, 5/9–2–9 (West 2007).
[26]ILCS, sec. 65, 5/9–2–45 (West 2007).
[27]ILCS, sec. 65, 5/9–2–46 (West 2007).
[28]ILCS, sec. 35, 200/27–25 (West 2007).
[29]ILCS, sec. 35, 200/27–45 (West 2007).
[30]ILCS, sec. 35, 200/27–75 (West 2007).
[31]Ibid.
[32]Ibid.
[33]ILCS, sec. 35, 200/27–87 (West 2007).
[34]See Thompson v. Village of Newark, 329 Ill.App.3d 536 (2002), which found that a non–home rule municipality lacked authority to impose an impact fee.
[35]ILCS, sec. 65, 5/11-15.1–2(d) (West 2007).

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