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## Local Government Finance as Integrated System: The Uneasy Case for Using Special Districts in Real Estate Finance (A Response to Odinet's *Super-Liens to the Rescue? A Case Against Special Districts in Real Estate Finance*)

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Local Government Finance as  
Integrated System: The Uneasy Case  
for Using Special Districts in Real  
Estate Finance (A Response to Odinet's  
*Super-Liens to the Rescue? A Case  
Against Special Districts in Real Estate  
Finance*)

Darien Shanske\*

*Abstract*

*Local governments have long used special financing districts to build infrastructure. If a local project, say building a pocket park, is likely to increase the values of properties very close to the park, then why should those properties not pay for the park in the first place? Though efficient and fair in many cases, the use of these districts can also be problematic. For instance, it seems likely that wealthier residents, with higher property values to leverage, are especially likely to use these districts effectively. It has also been the case that developers have used these districts speculatively, which had serious repercussions during the last recession. Christopher Odinet develops an additional, and important, critique of these districts. Odinet observes that these districts obtain a lien on benefiting properties, and that this lien takes priority over the liens of conventional lenders. Odinet then argues that this super-priority should only be honored if the district has served some substantial public purpose.*

*In this short Response, I agree with Odinet that these districts are problematic, but wonder whether his solution is the best one. This is because traditional lenders will generally know about*

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*these districts before lending. Furthermore, his solution only kicks in if there is an event of default, which is unusual, and thus, this solution does not do much to counter the run of the mill socio-economic stratification that these districts often enable. I argue that an ex ante approach limiting the use of these districts therefore seems preferable. I conclude with the argument that, despite all their flaws, these districts should not be abolished outright. Local government finance is a dynamic system and the absence of any tool, even one prone to abuse, can have severe consequences, as illustrated by the recent history of California.*

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### *I. Introduction*

We are usually aware of the general-purpose local governments that we live and work in—primarily counties and cities. We are often aware of some special-purpose local government entities, particularly school districts. We are probably not aware, however, of the many other special districts that abound in most states—water districts, utility districts, transportation districts, irrigation districts, and mosquito abatement districts, to name a few. According to the Census Bureau, in 2012, there were over 51,000 of such districts in the United States—more than the over 39,000 general-purpose governments.<sup>1</sup>

The Census Bureau undercounted. The Census Bureau’s criteria leave out many special districts with significant powers that are not sufficiently autonomous to make the Bureau’s list.<sup>2</sup>

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1. 2012 U.S. CENSUS BUREAU GOV’T ORG. SUMMARY REP. 1 (2013).

2. U.S. CENSUS BUREAU, G12-CG-ISD, INDIVIDUAL STATE DESCRIPTIONS: 2012, at vi (2013).

For instance, in California, the Census Bureau counted 2,861 special districts (other than school districts),<sup>3</sup> while California itself, which has somewhat looser criteria, counted 4,711 of such special districts—and all of those districts wielded significant fiscal power.<sup>4</sup>

The existence of these districts can be viewed from a number of perspectives. Looked at positively, they represent sensible attempts to achieve economies of scale or bring expertise to bear on a technical problem. Looked at negatively, such districts greatly complicate democratic accountability, and, indeed, they are often formed to evade limits, particularly as to incurring debt, that have been imposed by the people on the forms of government with which they are more familiar.

There is another kind of special district, one not accounted for by either the Census Bureau or the California State Controller, and this kind is perhaps as numerous as the special-purpose districts just described. This is the sublocal tax or assessment district.<sup>5</sup> A sublocal district is typically formed by a general-purpose local government, such as a city or county, but can also be formed by other entities, particularly school districts. Almost no one is aware of whether or not they live in “City of X, Assessment District # 2012-1.”

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3. *Id.* at 24.

4. 2012 CAL. STATE CONTROLLER SPECIAL DISTRICTS ANN. REP. iii.

5. How much more numerous is hard to say. As of 2012–2013, the California Debt Investment and Advisory Commission counted 891 of one type of these districts with debt outstanding. CAL. DEBT & INV. ADVISORY COMM’N, CDIAC No. 14.11, CALIFORNIA MELLO-ROOS COMMUNITY FACILITY DISTRICTS YEARLY FISCAL STATUS REP. 2012–2013 (2013). Not all of such districts have outstanding debt, and in California, there are other kinds of very similar districts. For more on trying to get a handle on the scope of these districts, see Christopher K. Odinet, *Super-Liens to the Rescue? A Case Against Special Districts in Real Estate Finance*, 72 WASH. & LEE L. REV. 707, 735–46 (2015) (setting forth the argument regarding special districts that the current Article responds to); Darien Shanske, Note, *Public Tax Dollars for Private Suburban Development: A First Report on a National Phenomenon*, 26 VA. TAX REV. 709, 711–12, 721–23 (2007) (providing a general analysis of Mello-Roos Tax Bonds). See generally Sara C. Galvan, *Wrestling with MUDS to Pin Down the Truth About Special Districts*, 75 FORDHAM L. REV. 3041 (2007) (discussing Texas districts and similar normative arguments on both sides).

The rationale for these sublocal districts is slightly different from the rationale for more independent special-purpose entities, such as water districts.<sup>6</sup> Take a classic case: a road needs to be built that connects a particular parcel of residential property to the main town. Suppose as well, to make the case easier, that this parcel is on a cul de sac and is at the end of the road. Without doubt, this property benefits from this road more than anyone else's, likely in a monetizable way. When the owner sells her property, now connected by a road, it will be worth more thanks to this public improvement. But why should the rest of the public pay for an improvement that so clearly benefits a particular property? Should general tax dollars not be saved for projects that provide more general benefits, such as, in this case, perhaps the larger road that many people will use in order to get to the smaller road that ends in the property owner's cul de sac? A sublocal district—usually called an assessment district—responds to this concern by creating a mechanism whereby the localizable value to be created by a public improvement can be harnessed to build the improvement in the first place.

Thus, in this classic case, the government will place an assessment on the owner's property to pay for her share of the road, say \$10,000, payable \$1,000 year over ten years. Because the government is fairly certain that she will pay this \$10,000 on schedule, it can borrow against these expected payments on very favorable terms in order to build the road. The government knows that it will collect this assessment because it will be collected along with property taxes, and, like a property tax, payment will be secured by a lien on the owner's property. As a tax lien, it will take priority over other liens.<sup>7</sup>

The use of such sublocal financings was once very common, with special assessment revenue making up a sizable portion of the revenue of major cities.<sup>8</sup> Currently, assessments are still

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6. See generally Darien Shanske, *Putting the California Constitution (Back) to Work: A Blueprint for Clearing Legal Roadblocks to Proper Infrastructure Finance*, 54 ST. TAX NOTES 567 (2009) (developing this argument further).

7. Odinet, *supra* note 5, at 749–50.

8. See Darien Shanske, *Attention Carbon Auditors: There's Low-Hanging Fruit in the PAB Regs*, 127 TAX NOTES 693, 705–07 (2010) (providing an overview of “the admittedly long history of assessment financing”); Stephen Diamond, *The Death and Transfiguration of Benefit Taxation: Special*

common, though much less so, and predominantly they are used to build infrastructure for new developments. Such speculative use of assessments is not new and, in fact, is one of the reasons their popularity declined during, and after, the Great Depression.<sup>9</sup> Therefore, one issue raised by these districts is to what extent they encourage harmful speculation.

These sublocal districts have begun to resemble other kinds of special districts in that they sometimes undertake limited governmental functions within the new development area. Given that these districts are put in place by developers for their own benefit, the assumption by the district of governmental roles poses normative challenges, such as whether it is appropriate for some people to get “less” local democracy than others because of how a developer once set up the community’s governance structure.<sup>10</sup> More fundamentally, there is the question of *how* the tools of local democracy are used in establishing sublocal districts. Because of the great flexibility usually available in designing, forming, and confirming these districts, it is easy for interested groups, beyond developers, to manipulate them.<sup>11</sup> In sum, there is a multi-headed democratic challenge posed by such districts.<sup>12</sup>

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*Assessments in Nineteenth-Century America*, 12 J. LEGAL STUD. 201, 202 (1983) (noting when special assessments originated in certain states and how they became increasingly common financing devices in the early 19th Century).

9. Diamond, *supra* note 8, at 240.

10. See Odinet, *supra* note 5, at 751–53 (noting the strikingly low participation in district board elections). See generally Nadav Shoked, *Quasi-Cities*, 93 B.U. L. REV. 1971 (2013) (explaining how special districts that function like cities often undermine the objectives of local government law).

11. See Vladimir Kogan & Mathew D. McCubbins, *The Problem With Being Special: Democratic Values and Special Assessments*, 14 PUB. WORKS MGMT. & POL’Y 4, 30 (2009) (“[T]hrough the institutional structures of modern assessments do appear to prevent downward redistribution, they leave the system vulnerable to strategic manipulation by large property owners and businesses, who can more easily overcome the problems of collective action, in effect transforming assessments into a potential tool for upward redistribution.”).

12. There are also federal tax challenges. See Darien Shanske, *The Feds Are Already Here: The Federal Role in Regulating Municipal Debt Finance*, 33 B.U. REV. BANKING & FIN. L. 795, 805–09 (2014) (discussing a challenge actually raised by the IRS). See generally Shanske, *supra* note 8 (arguing that these districts should be challenged on other federal tax grounds).

There are other related reasons one might be concerned about such districts. If they are particularly good at building infrastructure in undeveloped areas, as they seem to be, then they are tools for sprawl pattern development. Sprawl pattern development causes environmental and socio-economic problems. After all, it will be the wealthy who are likely most able to self-finance the improvements that they would like, in splendid isolation.<sup>13</sup>

## II. Odinet's Argument

In his analysis of these districts,<sup>14</sup> Odinet places them in much the same context as outlined above,<sup>15</sup> though, crucially, he adds one additional, novel, and very interesting critique: sublocal districts used to finance real estate improvements cause problems for traditional lenders because these districts obtain a lien that is superior to the lien obtained by the traditional lender.<sup>16</sup> Odinet's proposed judicial balancing test would mitigate this problem. His test even takes into account many of the normative concerns with these districts already adduced.<sup>17</sup> Specifically, if challenged in court, the priority of the development district loan would depend on whether the district provided a community benefit that justified this priority.

Odinet's analysis fails, however, to justify its concern for traditional lenders. Odinet explains the long history of special districts,<sup>18</sup> as well as their prevalence in many regions. It is, therefore, difficult to see how traditional lenders are being blindsided. Indeed, Odinet also explains why these districts are

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13. See generally Darien Shanske, *Above All Else Stop Digging: Local Government Law as a Cause (and Solution) to the Current Financial Crisis*, 43 U. MICH. J.L. REFORM 663 (2010) (explaining how wealthy homeowners generally use zoning and other tools to isolate themselves from other socio-economic groups).

14. Odinet, *supra* note 5.

15. Odinet arguably assimilates these districts too much to special districts more broadly.

16. Odinet, *supra* note 5, at 753–73.

17. *Id.* at 785–88.

18. *Id.* at 737–46.

so favorable for developers.<sup>19</sup> Because this is usually the case—for example, where the district does not fail—the traditional lenders likely share in the benefit that the developer enjoys through being permitted to use a governmental structure to finance essentially private development.<sup>20</sup>

It could be countered that sublocal financing of this sort is inherently unstable, and thus, a downturn could materialize and undermine traditional lenders. This is the concern, noted above, that these districts are too likely to encourage speculation. Many thought, including this commentator, that speculative land-secured districts would fall like dominoes during a prolonged downturn,<sup>21</sup> and so they did during the Great Recession in some states, such as Florida, but not, for instance, in California. There is a reason for this. Safeguards put in place—such as minimum lien-to-value ratios and reserve funds—after the bust of the early 1990s in California effectively insulated many California districts. There is, therefore, a way to mitigate the risk of these districts enabling excessive speculation—other states, such as Florida, should copy the California requirements.<sup>22</sup>

In developing the argument that there are financing problems caused by these districts, Odinet emphasizes that the Federal Housing Finance Agency (FHFA) turned against sublocal districts if the districts were established to finance solar panels and other energy-saving improvements. These districts were part of Property Assessed Clean Energy (PACE) programs.<sup>23</sup>

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19. *Id.* at 773–78.

20. Odinet seems aware of this concern but does not directly address it. *Id.* at 720 n.38.

21. Shanske, *supra* note 5, at 744–45.

22. See Robert W. Doty, *The Readily Identifiable Riskiest Municipal Securities: Due Diligence Does Make a Difference*, 32 MUN. FIN. J. 63, 70–75 (2011) (contrasting default experiences in land-based financing in Florida and California). Note that this is not to say that there is not room for improvement with California Mello-Roos bonds. See, e.g., Keeley Webster, *California Report Takes Aim at Mello-Roos Bonds*, THE BOND BUYER (July 23, 2015, 2:30 PM), <http://www.bondbuyer.com/news/regionalnews/california-report-takes-aim-at-mello-roos-bonds-1079926-1.html> (“An Orange County, Calif. civil grand jury report criticized the oversight of \$2.7 billion of debt issued by community facilities districts in the county.”).

23. Odinet, *supra* note 5, at 772.

Specifically, the FHFA declared that Fannie Mae and Freddie Mac would stop purchasing mortgages of properties within PACE districts.<sup>24</sup> This admittedly was a major event, essentially destroying a (potentially) worthwhile local experiment,<sup>25</sup> and the super priority of these districts' liens was a stated reason for this policy.

Yet, it seems that Odinet gives this decision too much weight. After all, Fannie and Freddie did not stop buying the mortgages of the many homes in special districts generally, largely because these districts are a well-known mechanism for financing essential infrastructure. If a development district did not build the roads and the sewers, then a developer would have to build them and pass on a higher price to the home purchasers. In contrast, it seems that the FHFA was responding, perhaps hyperbolically, to policy and implementation concerns with the program.<sup>26</sup> For instance, unlike sewers, solar panels are not considered essential by everyone, and so it is not clear what subsequent homeowners would think about taking on a special lien for solar panels. Also, though sewer lines do wear out, they do not become obsolete in the same way that solar panels do. In short, the FHFA seems to have been concerned about many other matters other than the simple "super lien" status.<sup>27</sup>

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24. *Id.*

25. For the critique, see generally Prentiss Cox, *Keeping PACE?: The Case Against Property Assessed Clean Energy Financing Programs*, 83 U. COLO. L. REV. 83 (2011) (arguing that the theory behind PACE is fundamentally flawed).

26. See generally *id.* (providing a more in-depth exploration of this critique).

27. And the FHFA said as much:

First liens established by PACE loans are unlike routine tax assessments and pose unusual and difficult risk management challenges for lenders, servicers and mortgage securities investors. The size and duration of PACE loans exceed typical local tax programs and do not have the traditional community benefits associated with taxing initiatives.

Press Release, Fed. Hous. Fin. Agency, FHFA Statement on Certain Energy Retrofit Loan Programs (July 6, 2010), <http://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Statement-on-Certain-Energy-Retrofit-Loan-Programs.aspx> (on file with the Washington and Lee Law Review). The federal government continues to be concerned with aspects of PACE programs beyond the super-lien issue. For instance, in its latest guidance on the issue, the federal government will insist that PACE programs not only have subordinate liens, but that the PACE programs provide adequate

The more powerful critiques of these districts are those addressed in this Response's introduction, those based on broader considerations of political economy and justice.<sup>28</sup> Odinet's article explicitly and implicitly develops these critiques. For instance, Odinet discusses how the availability of these districts impel local governments and developers to chase one another, looking for supposed mutual win-wins, rather than search for projects that aid the common good.<sup>29</sup> Odinet also describes the kind of gilded community that these districts are likely to finance<sup>30</sup>—these districts will likely increase segregation along multiple dimensions, not to mention sprawl. Odinet argues, reasonably, that a court should consider whether a district is serving an underserved community *ex post* when evaluating the priority of the district's lien.<sup>31</sup> This Response argues that legislatures should only permit such districts to advance broad social goals *ex ante* through, for instance, rules on the kinds of infrastructure than can be financed—for instance, not allowing districts to fund golf course projects.<sup>32</sup>

There are two specific reasons this Response advocates an *ex ante* approach. First, if we followed Odinet, we would make the sublocal district lien subject to a balancing test, which would destabilize the rights of *both* the traditional lenders and district bondholders. That said, as argued above, we should not be overly concerned about traditional lenders. Furthermore, other reforms could lower the risk of default for these districts, so this clash of priorities should not be a regular occurrence, even during an

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consumer disclosures. U.S. DEP'T OF HOUS. & URBAN DEV., GUIDANCE FOR USE OF FHA FINANCING ON HOMES WITH EXISTING PACE LIENS AND FLEXIBLE UNDERWRITING THROUGH ENERGY DEPARTMENT'S HOME ENERGY SCORE (2015).

28. See also Kenneth A. Stahl, *Neighborhood Empowerment and the Future of the City*, 161 U. PA. L. REV. 939, 941–46 (2013) (critiquing assessment districts). See generally Nadav Shoked, *The New Local*, 100 VA. L. REV. 1323 (2014) (providing a broader normative critique of micro-localism); Shanske, *supra* note 13 (same).

29. Odinet, *supra* note 5, at 777–78.

30. The district in the opening example is to be used to finance a tennis court, a golf course, and a swimming pool. *Id.* at 709–11; see also Shanske, *supra* note 13, at 665–70 (providing an actual example).

31. Odinet, *supra* note 5, at 785–88.

32. Shanske, *supra* note 13, at 707–08.

economic downturn. Thus, rights would be destabilized for little reason. Therefore, in order to achieve Odinet's normative goals, an *ex ante* approach for assessing community benefit is more promising. That said, I do not see why both an *ex ante* and *ex post* solution could not be adopted at the same time.

### *III. Conclusion*

One could argue that none of this is worth the trouble—that neither Odinet's reform nor this Response's proffered reform would be adequate. Even if subject to sensible restrictions, there will always be a likelihood that powerful interest groups will capture the use of sublocal district financing and push for its use in more speculative projects—or at the very least, projects that are normatively suboptimal. This might suggest dramatically limiting such financing structures or taking the final step and barring them outright. Such an approach would be a mistake for two important reasons—or rather, one reason, with a positive and a negative component. The negative component in particular has not been well articulated up until this point.

First, the positive reason: the rationale for sublocal value capture finance often holds true and, because of this, such financings can serve as an important corrective for pathologies that might otherwise develop in local politics. Public infrastructure often disproportionately benefits a specific piece of private property. When this benefit is specified with reasonable precision, it not only allows for financing of infrastructure to occur through the assessment mechanism, but it also encourages a more frank evaluation of whether it should occur. For instance, most property owners would agree that general tax dollars should be used to improve the park across the street from their houses, but they may not feel the same way if they are specially assessed for that local improvement. If they do not agree with being specially assessed for the improvement, then maybe the project is not a good one. If most property owners support the assessment however, and the assessment succeeds, then perhaps the general park budget can be spent on a public pool for the whole town.

Regarding the negative reason for why we need sublocal district financing, we should consider the scenario where a

property owner does not want an improvement but is assessed for one anyway. Though there are safeguards, in the end, the assessment is a coercive financing tool. If it were not, then it would not work properly. Very few projects command unanimous consent. This point about coercion underscores that these districts are just another governmental tool—not necessarily better or worse in the abstract. A local government could use general tax dollars to fund a park, use fees to fund a park, try to impose some kind of regulatory mandate to compel a private party to provide a park, so on and so forth. If the best tool is not available, then the government will use a different one if it can—like trying to use a screwdriver to hammer in a nail.

Using the wrong tool has costs—direct and indirect, predictable and unpredictable. In the simple scenario above, using the general park budget to fix up small neighborhood parks prevents funding citywide amenities. Or perhaps the local parks would not be fixed at all. If the park is not funded, then the direct cost is a value-enhancing amenity that could have funded itself. Various kinds of indirect costs are possible, such as the eventual need for more policing of a park that no one uses because it is rundown. On the other hand, if a sublocal park is funded with general tax dollars there are also costs, such as the political economy problem of different neighborhoods all clamoring for general tax dollars to improve their local park. A follow-on problem to this is that voters seem eventually to respond to misuse of instruments.

There has been something of a natural experiment of this in California. I will tell the story, which is, of course, controversial in all respects, in outline. In 1978, via Proposition 13, the voters of California permanently reduced the local property tax, which had been the mainstay of local government.<sup>33</sup> Without the ability to use the property tax as they had before, California local governments looked to other tools, particularly assessments, to fund projects that the voters apparently wanted and that had previously been funded with the property tax. In response to the perceived aggressive use of assessments, California voters made

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33. See CAL. CONST. art. XIII A (incorporating Proposition 13).

it much harder to use assessments via Proposition 218 in 1996.<sup>34</sup> In the wake of Proposition 13, California local governments also turned more and more to fees. Proposition 26, passed in 2010, made it harder to impose fees.<sup>35</sup> Whether the accusations of widespread abuse were fair in any of these cases is very much in doubt, but it is not controversial that California local governments felt compelled to use suboptimal mechanisms more frequently as their better options were taken away from them.

The sad story of California's systematic self-destruction of the traditional tools of local public finance illustrates the dynamic relationship between the various tools of public finance and local political economies. Sublocal financing is essential, if for no other reason than it is obviously appropriate in certain contexts. If a different financing expedient is used when a sublocal assessment district is the right tool, then the consequences will likely be worse than tolerating an occasional default, a developer making out like a bandit, or yet another way that the wealthy and powerful can feather their nests. This is because, in the end, we all benefit from a functional system of public finance. Thus, making incremental reforms to sublocal financing mechanisms, such that they are a little more equitable, is extremely worthwhile—hence the importance of Odinet's contribution.

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34. See *id.* arts. XIII C and XIII D (incorporating Proposition 218).

35. See *id.* arts. XIII A, § 3 and XIII C, § 1 (incorporating Proposition 26).